Supreme Court, U.S.
FILED

No. 94-618 OCT - 5 1994

OFFICE OF THE CLERK

In The

Supreme Court of the United States

October Term, 1994

STATE OF IOWA, TERRY E. BRANSTAD, and
IOWA FRANCHISEE ASSOCIATION,

Petitioners,

v.

HOLIDAY INNS FRANCHISING, INC.,
HOLIDAY INNS, INC., and
MCDONALD'S CORPORATION,

Respondents.

**Joint Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Eighth Circuit**

PETITION FOR WRIT OF CERTIORARI

BONNIE CAMPBELL
Attorney General of Iowa

GORDON E. ALLEN*
Deputy Attorney General

MARK HUNACEK
Assistant Attorney General
Office of the Attorney General
Second Floor
Hoover State Office Bldg.
Des Moines, Iowa 50319
(515) 281-5166
FAX (515) 281-4209

Counsel for Petitioners, State of Iowa and Terry E. Branstad

BRENT R. APPEL*
DICKINSON, MACKAMAN, TYLER & HAGEN
A Professional Corporation
1600 Hub Tower
699 Walnut Street
Des Moines, IA 50309
(515) 244-2600
FAX (515) 246-4550

Counsel for Petitioner Iowa Franchisee Association

*Counsel of Record

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

QUESTIONS PRESENTED

1. Whether a state franchising statute prohibiting unfair or abusive practices by franchisors should be held invalid under the Contract Clause of the United States Constitution when applied to franchisor-franchisee agreements in effect at the time of the statute's effective date in the absence of any discussion of the public purposes served by the statute.

2. Whether the public purpose of prohibiting unfair or abusive practices by franchisors is a significant and legitimate public purpose under the Contract Clause which justifies contractual impairments, substantial or otherwise, caused by specific provisions of a state franchising statute regulating termination, transfer, nonrenewal, and encroachment.

3. Whether specific provisions of a state franchising statute regulating unfair or abusive practices of franchisors in termination, transfer, nonrenewal, and encroachment can be invalidated under the Contract Clause in the absence of any consideration of the precise nature of the contractual rights in question and the extent to which those rights have been impaired.

4. Whether a substantial contractual impairment under the Contract Clause can be established based on provisions of a state statute regulating unfair or abusive practices of franchisors in termination, transfer, nonrenewal, and encroachment where certain of those statutory provisions are virtually identical to state common law and where there is a rich history of regulatory, common law, and business concern over those same unfair and abusive practices that the statute is designed to regulate.

PARTIES TO PROCEEDINGS

Petitioners are the State of Iowa, Terry E. Branstad, Governor of the State of Iowa, and the Iowa Franchisee Association.

Respondents are Holiday Inns Franchising, Inc., Holiday Inns, Inc., and McDonald's Corporation.

TABLE OF CONTENTS

Page

Questions Presented i

Parties to Proceedings ii

Table of Contents..... iii

Table of Authorities v

Opinion Below 1

Jurisdiction..... 2

Constitutional and Statutory Provisions Involved... 3

Statement of the Case 3

Reasons for Granting the Writ 7

I. The Decision of the Eighth Circuit Court of Appeals, Invalidating the Application of Specific Provisions of the Iowa Franchise Act to Existing Agreements Without Even Considering the Public Purposes Served by the Act, Conflicts with Contract Clause Decisions of this Court, Other Federal Courts of Appeal, and State Courts of Last Resort on an Issue of National Importance..... 8

II. The Public Purpose of Prohibiting Unfair or Abusive Practices by Franchisors Is a Significant and Legitimate Public Purpose Under the Contract Clause Which Justifies Impairments, Substantial or Otherwise, to Existing Contracts Caused by Individual Provisions of a State Statute Regulating Termination, Transfer, Nonrenewal, and Encroachment .. 10

TABLE OF CONTENTS – Continued

Page

III. The Decision of the Eighth Circuit Court of Appeals, Invalidating the Application of Specific Provisions of the Iowa Franchise Act to Existing Agreements Absent Any Consideration of the Precise Nature of the Contractual Rights Involved and the Extent to Which Those Rights Had Been Impaired, Is Contrary to Decisions of This Court and Inappropriately Invades the Province of the State Legislature 14

IV. Provisions of Iowa's Franchise Act Governing Termination, Transfer, Nonrenewal, and Encroachment Do Not Substantially Impair Rights and Obligations in Existing Contracts Since Certain of Those Statutory Provisions Are Virtually Identical to State Common Law and There Exists a Rich History of Regulatory, Common Law, and Business Concern Over the Unfair and Abusive Practices the Act Is Designed to Regulate 19

Conclusion 21

Appendix

Exhibit A – Decision of the Eighth Circuit Court of Appeals..... App. 1

Exhibit B – Opinion of the United States District Court for the Southern District of Iowa..... App. 7

Exhibit C – Statutory Provisions..... App. 36

TABLE OF AUTHORITIES

Page

Adair Benev. Soc. v. State Ins. Div., 489 N.W.2d 1 (Iowa 1992) 3

Anderson's Vehicle Sales, Inc. v. OMC-Lincoln, 287 N.W.2d 247 (Mich. 1979) 13

Arnott v. American Oil Co., 609 F.2d 873 (8th Cir. 1979) 12

Bain v. Champlin Petroleum Co., 692 F.2d 43 (8th Cir. 1982) 12

Boatland, Inc. v. Brunswick Corp., 558 F.2d 818 (6th Cir. 1977) 12

Domed Stadium Hotel, Inc. v. Holiday Inns, Inc., 732 F.2d 480 (5th Cir. 1984) 12

Energy Reserves Group, Inc. v. Kansas Power and Light Co., 459 U.S. 400 (1983) 8, 9, 13, 14, 19, 20

Exxon Corp. v. Eagerton, 462 U.S. 176 (1983) 15, 18

General Motors Group v. Romein, ___U.S.___, 112 S.Ct. 1105, 117 L.Ed.2d 328 (1992) 14, 15, 18

General Offshore Corp. v. Farrelly, 743 F. Supp. 1177 (D. Virgin Islands 1990) 17, 18

Holiday Inns Franchising, Inc. v. Branstad, 29 F.3d 383 (8th Cir. 1994) 1, 6, 9, 15

Keystone Bituminous Coal Ass'n v. DeBenedictis, 480 U.S. 470 (1987) 14, 18

Larese v. Creamland Dairies, Inc., 767 F.2d 716 (10th Cir. 1985) 12

McDonald's Corp. v. Nelson, 822 F. Supp. 597 (S.D. Iowa 1993) 2, 3, 5, 11, 16

TABLE OF AUTHORITIES – Continued

Page

Midwest Management Corp. v. Stephens, 291 N.W.2d 896 (Iowa 1980) 20

Modern Computer Systems v. Modern Banking Systems, 871 F.2d 734 (8th Cir. 1989) 11

Scheck v. Burger King Corp., 756 F. Supp. 543 (S.D. Fla. 1991) 12

Schieffelin & Co. v. Dep't of Liquor Control, 479 A.2d 1191 (Conn. 1984) 13, 19

Shell Oil Co. v. Marinello, 294 A.2d 253 (N.J.Super.Ct. 1972) 12

Troy Ltd. v. Renna, 727 F.2d 287 (3rd Cir. 1984) 13

United States Trust Co. v. New Jersey, 431 U.S. 1 (1977) 17

Westfield Centre Service, Inc. v. Cities Service Oil Co., 86 N.J. 453, 432 A.2d 48 (1981) 12

STATUTES AND CONSTITUTIONAL PROVISIONS

28 U.S.C. § 1254(1) 2

28 U.S.C. § 1292(b) 2, 5

28 U.S.C. § 1331 2

28 U.S.C. § 1367 2

28 U.S.C. § 2201 2

Iowa Code § 523H.2 4

Iowa Code § 523H.5 5

Iowa Code § 523H.6 ..... 4, 5

Iowa Code § 523H.7 ..... 4, 5, 16

TABLE OF AUTHORITIES – Continued

Page

Iowa Code § 523H.8 ..... 5, 16, 20

U.S.Const. art. 1, § 10, cl. 1 3

Iowa Const. art. 1, § 21 3

MISCELLANEOUS AUTHORITIES

Comment, *Franchise Termination and Nonrenewal*, 26 S.D. L. Rev. 321 (1981) 10

Franchise Self Regulation, CCH Business Franchise Guide, No. 156 (Dec. 18, 1992) 20

Greco, *Adjusting the Equities in Franchise Termination: A Sui Generis Approach*, 30 Cleveland St. L. Rev. 523 (1981) 11

Note, *Constitutional Obstacles to State "Good Cause" Restrictions on Franchise Terminations*, 74 Columbia L. Rev. 1487 (1974) 10

Piegoff, *Franchise Relationship Laws: A Minefield for Franchisors*, 45 Bus. Lawyer 289 (1989) 11

Rau, *Implied Obligations in Franchising: Beyond Terminations*, 47 Bus. Lawyer 1053 (1992) 10

No. _____

In The

Supreme Court of the United States

October Term, 1994

STATE OF IOWA, TERRY E. BRANSTAD, and
IOWA FRANCHISEE ASSOCIATION,

Petitioners,

v.

HOLIDAY INNS FRANCHISING, INC.,
HOLIDAY INNS, INC., and
MCDONALD'S CORPORATION,

Respondents.

**Joint Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Eighth Circuit**

PETITION FOR WRIT OF CERTIORARI

Petitioners the State of Iowa, Terry E. Branstad, and the Iowa Franchisee Association respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Eighth Circuit entered on July 7, 1994.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Eighth Circuit is reported at 29 F.3d 383 (8th Cir.

1994). A copy of that opinion is included in the Appendix as Exhibit A.

The District Court decision affirmed by the Eighth Circuit is reported at 822 F. Supp. 597 (S.D. Iowa 1993). A copy of that opinion is included in the Appendix as Exhibit B.

JURISDICTION

Jurisdiction in this case is premised upon 28 U.S.C. § 1254(1) for review by certiorari of the judgment and opinion of the United States Court of Appeals for the Eighth Circuit. A written opinion was issued by that Court on July 7, 1994.

Jurisdiction in the District Court was based on 28 U.S.C. §§ 1331, 1367, and 2201. Jurisdiction in the Eighth Circuit Court of Appeals was based on 28 U.S.C. § 1292(b). The District Court, on its own motion, determined that this case was one which involved a controlling question of law as to which there is substantial ground for difference of opinion and certified an immediate appeal from the adjudication of the litigation. *McDonald's Corp. v. Nelson*, 822 F. Supp. 597, 609 (S.D. Iowa 1993) (App. 34). The Eighth Circuit then granted petitioners' request for interlocutory appeal.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The constitutional provision involved is the Contracts Clause of the United States Constitution, U.S. Const. art. 1, § 10, cl. 1: "No state shall . . . pass any . . . Law impairing the Obligation of Contracts. . . . " Plaintiff McDonald's Complaint for Declaratory Judgment filed with the federal district court specifically noted that all claims arising under the Constitution and laws of the State of Iowa involve the same nucleus of operative facts and are supplemental to the federal claims. The language of the Iowa Contract Clause, Iowa Const. art. 1, § 21 ("No . . . law impairing the obligation of contracts, shall ever be passed."), and the analysis employed in assesing the constitutionality of statutes under it are substantially the same as the language of and analysis under the federal Contract Clause. *McDonald's Corp.*, 822 F. Supp. at 605, *citing Adair Benev. Soc. v. State Ins. Div.*, 489 N.W.2d 1, 5 (Iowa 1992) (App. 25). The district court and the Eighth Circuit ruled the challenged provisions of the Iowa Franchise Act unconstitutional under both the federal and state Constitutions, placing exclusive reliance upon federal authorities.

Relevant portions of the state statute at issue, the Iowa Franchise Act (Iowa Code Chapter 523H), are set forth in the Appendix as Exhibit C.

STATEMENT OF THE CASE

The day after the enactment of Iowa Code Chapter 523H, the Iowa Franchise Act, respondents, Holiday Inns

Franchising, Inc. and Holiday Inns, Inc., brought an action in federal district court challenging its constitutionality. Iowa Governor Terry E. Branstad was named as a defendant in that action, as were several franchisees of the plaintiffs [respondents here]. In a separate action, respondent McDonald's Corporation brought suit against two of its franchisees, also alleging that Chapter 523H was constitutionally infirm. The State of Iowa, though not named as a defendant in that action, received permission from the court to intervene as a defendant. In addition, the Iowa Franchisee Association sought and obtained permission to intervene as a defendant in both actions.

The Iowa Franchise Act, which became effective on July 1, 1992, contains a number of provisions governing activities of franchisors and franchisees in an effort to avoid certain conduct found by the legislature to be abusive or unfair. The four aspects of the statute that are pertinent to this appeal involve termination, nonrenewal, encroachment and transfer of a franchise. For example, the statute allows a franchisor to terminate a franchise or to refuse to renew a franchise, subject to "good cause" and notice. Iowa Code § 523H.7. The statute also requires that prior to establishing a new outlet within unreasonable proximity of an existing franchise, the franchisor must give the existing franchisee a right of first refusal or a right to compensation for market share diverted by the new outlet. Iowa Code § 523H.6. It is undisputed that the statute, by its terms, applies to existing franchise agreements as well as to agreements entered into after the effective date of the Act. Iowa Code § 523H.2.

The plaintiffs in both cases moved for partial summary judgment, contending that the application of designated provisions of the Act to existing franchise agreements violated the Contract Clause of the United States Constitution as well as the Contract Clause of the Iowa Constitution. All petitioners resisted the motions and the State of Iowa and Governor Branstad cross-moved for summary judgment. While these cases have not been consolidated for purposes of trial of the remaining issues, the district court considered the partial motions for summary judgment and cross-motions together and entered one consolidated order.

The district court concluded that the application of challenged provisions of the Act[1] to existing contracts violated the Contract Clause and granted plaintiffs' motions for partial summary judgment. *McDonald's Corp. v. Nelson*, 822 F. Supp. 597, 609 (S.D. Iowa 1993). (App. 34-35.) The district court, on its own motion, certified this case for immediate appeal pursuant to 28 U.S.C. § 1292(b). The Eighth Circuit Court of Appeals granted petitioners' petition for permission to appeal and on appeal affirmed the decision of the district court.

Significantly, in affirming the district court the Eighth Circuit did not address at all the public purpose served by the Act. Instead, the Court began and ended its analysis with the observation that the Act substantially

---

[1] Iowa Code § 523H.5(1), (4), (5), (13)(d), (13)(e), (13)(g), addressing transfers of franchises; § 523H.6, addressing encroachment; § 523H.7, addressing termination of franchise agreements; and § 523H.8, addressing renewals of franchise agreements.

impaired existing contracts. Repeated language in the opinion suggests that the Court believed that any substantial impairment of a contract was unconstitutional. The Court referred in the first paragraph of its opinion to plaintiffs' belief that the Act "substantially *and thus* unconstitutionally" impaired the obligation of a contractor, *Holiday Inns Franchising, Inc. v. Branstad*, 29 F.3d 383, 384 (8th Cir. 1994) (App. 4), and later in the opinion the Court stated that "in determining whether an impairment is substantial, *and thus* unconstitutional. . . . " *Id.* (App. 4) (Emphasis added.) The decision of the Eighth Circuit clearly implies that any legislation which substantially impairs a contract is void, regardless of the severity of the harms sought to be corrected by the statute.

The Eighth Circuit's decision is also devoid of any analysis regarding the alleged substantial impairments. Rather, the Court simply acquiesced in the findings and conclusions of the district court, *Holiday Inns*, 29 F.3d at 384 (App. 4), a decision which, itself, fails to analyze the precise nature of the contractual rights in question. Rather, the district court simply outlined the provisions of the contracts in question and set forth the asserted expectations of plaintiffs when entering into those contracts. At no time did the district court examine the precise contractual terms in light of statutory language, regulatory history, or other matters relevant to Contract Clause review. The district court concluded that contractual expectations of the parties at the time of execution of these agreements had been materially altered by the statute – a conclusion flowing from a facial comparison of statutory terms with plaintiffs' statements of what they expected the contracts to do. In seemingly accepting this

analytical approach, the Eighth Circuit has departed from established Contract Clause analysis and in its place has essentially held that any impairment of an existing contract that facially alters the asserted expectations of a party to that contract constitutes a substantial impairment.

REASONS FOR GRANTING THE WRIT

The essential requirements of Contract Clause analysis look to the precise nature of the contractual right and asserted statutory impairment and, if substantial impairment is found, to the public purpose supporting the statute. Both prongs of Contract Clause evaluation are critical; neither prong is optional. Complete failure by the Eighth Circuit Court of Appeals to address the public purposes behind the state's statutory scheme is a serious flaw that, if allowed to stand, irrefutably alters a major component of Contract Clause analysis contrary to long-established principles of constitutional law adhered to by this Court, the federal courts of appeal, and state courts of last resort and, further, leaves no room for state legislative discretion in addressing policy issues of any sort where existing contracts might be impacted. Similarly, failure to appropriately analyze the precise provisions of the contracts in question in light of statutory language, legislative history, and other recognized factors of review upsets the critical balance of interests long-established in Contract Clause jurisprudence, thereby diverting appropriate inquiry from essential issues of contractual impairment to an immediate evaluation of the wisdom and acceptability of a state statute. Adherence to the required

prongs of Contract Clause analysis in this case would establish that no constitutional impairment exists and, further, that the provisions of Iowa's Franchise Act are amply supported by significant and legitimate public policy considerations.

I. THE DECISION OF THE EIGHTH CIRCUIT COURT OF APPEALS, INVALIDATING THE APPLICATION OF THE IOWA FRANCHISE ACT TO EXISTING AGREEMENTS WITHOUT EVEN CONSIDERING THE PUBLIC PURPOSES SERVED BY THE ACT, CONFLICTS WITH CONTRACT CLAUSE DECISIONS OF THIS COURT, OTHER FEDERAL COURTS OF APPEAL, AND STATE COURTS OF LAST RESORT ON AN ISSUE OF NATIONAL IMPORTANCE.

In any case in which it is alleged that a state law violates the Contract Clause, the first inquiry is whether the law has, in fact, operated as a substantial impairment of a contractual relationship. *Energy Reserve Group, Inc. v. Kansas Power and Light Co.*, 459 U.S. 400, 411 (1983). If a substantial impairment is found, the inquiry is not over. Instead, the court looks to whether there is a significant and legitimate public purpose behind the law. *Id.* One such public purpose is "the remedying of a broad and general social or economic problem." *Id.* at 412. The public purpose need not be addressed to an emergency or temporary situation. Finally, once a legitimate public purpose has been identified, the question becomes whether the adjustment of "the rights and responsibilities of contracting parties [is based] upon reasonable conditions and

[is] of a character appropriate to the public purpose justifying [the legislation's] adoption." *Id.* Unless the state is itself a contracting party (which it is not in this case), "courts properly defer to legislative judgment as to the necessity and reasonableness of a particular measure". *Id.* at 413.

In this case, the Eighth Circuit first considered the question of substantial impairment, and, having found substantial impairment, apparently concluded *on that basis alone* that the Iowa Franchise Act was unconstitutional. *Holiday Inns*, 29 F.3d at 384 (App. 4). By failing to even consider the public purpose of the Act (which has been extensively discussed by courts and commentators for decades), the Eighth Circuit failed to apply the legal standard mandated by this Court.

The use of the incorrect legal standard in this case has implications far beyond the franchising context. By substantially weakening the test to be applied in Contract Clause analysis, the Eighth Circuit has correspondingly weakened the ability of states to pass remedial legislation of any nature. At the very least, the Eighth Circuit has in essence adopted a form of "strict scrutiny" for any legislation which substantially impairs an existing contract, and, at most, the court has adopted an absolute prohibition against substantial impairments regardless of the necessity for that legislation.

This Court has repeatedly and unequivocally stated that while the language of the Contract Clause is facially absolute, its prohibitions must be weighed against the state's interest in protecting the public from social and economic harm. *Energy Reserves*, 459 U.S. at 410. The

decision of the Eighth Circuit, which improperly ignores the public purpose to be served by the Act, conflicts with the decisions of this Court as well as the decisions of any lower court which properly applies the three-part Contract Clause standard. That conflict carries with it attendant consequences impacting the ability of a legislature to pass remedial legislation.

II. THE PUBLIC PURPOSE OF PROHIBITING UNFAIR OR ABUSIVE PRACTICES BY FRANCHISORS IS A SIGNIFICANT AND LEGITIMATE PUBLIC PURPOSE UNDER THE CONTRACT CLAUSE WHICH JUSTIFIES IMPAIRMENTS, SUBSTANTIAL OR OTHERWISE, TO EXISTING CONTRACTS UNDER PROVISIONS OF THE IOWA FRANCHISE ACT REGULATING TERMINATION, TRANSFER, NONRENEWAL, AND ENCROACHMENT.

It is certainly no exaggeration to say that franchising is a pervasive method of doing business in America today. It is a method of doing business that touches on food supply, accommodations, automobile dealerships and a host of other activities.

Franchising is also an endeavor which, by virtue of the unique relationship between the franchisor and franchisee, results in built-in inequalities and potential for abuse. Rau, *Implied Obligations in Franchising: Beyond Terminations*, 47 Bus. Lawyer 1053, 1053 (1992); Comment, *Franchise Termination and Nonrenewal*, 26 S.D. L. Rev. 321, 322 (1981); Note, *Constitutional Obstacles to State "Good Cause" Restrictions on Franchise Terminations*, 74 Columbia L. Rev. 1487, 1487-88 (1974). This potential for abuse is

not just conjectural. Indeed, the Eighth Circuit Court of Appeals has itself pointed out that the literature of franchising law "is strewn with reports of sophisticated and financially powerful franchisors taking advantage of relatively inexperienced franchisees". *Modern Computer Systems v. Modern Banking Systems*, 871 F.2d 734, 739 (8th Cir. 1989).

Such abuses are part of the summary judgment record in this case. The Iowa legislature, prior to passing the Act, convened the Franchise Regulation Interim Study Committee which heard a number of specific instances of abusive and unfair practices. In addition, as the district court noted, "others who wanted to appear and present statements did not out of fear of repercussions by their franchisors." *McDonald's*, 822 F. Supp. at 608 n.9 (App. 32).

The potential for abuse, and the actual abuses that have occurred, has led to the passage of legislation on both the federal and state level concerning franchise relationships of one form or another. "The onslaught of lawsuits in this area has not gone unnoticed by legislatures. Almost every state has made at least one attempt of regulating the franchise method of doing business." Greco, *Adjusting the Equities in Franchise Termination: A Sui Generis Approach*, 30 Cleveland St. L. Rev. 523, 524 (1981). While some of these statutes have been limited to particular kinds of franchises (for example motor vehicle franchises), a number have been of the "general franchise regulation" type. Various franchise laws across the country are indexed and discussed in Peigoff, *Franchise Relationship Laws: A Minefield for Franchisors*, 45 Bus. Lawyer 289 (1989). This summary shows that "good cause"

requirements, as well as encroachment and transfer provisions, are not unique to the Iowa Act. The author also points out that other states have encroachment and transfer provisions. *Id.* at 329-330. A number of courts, including the Eighth Circuit, have spoken with approval of the public purposes motivating such legislation. *Bain v. Champlin Petroleum Co.*, 692 F.2d 43, 48 (8th Cir. 1982); *Arnott v. American Oil Co.*, 609 F.2d 873, 882-883 (8th Cir. 1979); *Boatland, Inc. v. Brunswick Corp.*, 558 F.2d 818, 823 (6th Cir. 1977); *Westfield Centre Service, Inc. v. Cities Service Oil Co.*, 86 N.J. 453, 432 A.2d 48, 53 (1981).

In another reflection on the important public policy purposes served by legislation such as the Act, other courts have adopted common law rules restricting the rights of franchisors to engage in completely arbitrary conduct towards franchisees. One court, for example, noted that in cases of franchise termination, "courts have refused to give literal effect to the language of the franchise agreement." *Domed Stadium Hotel, Inc. v. Holiday Inns, Inc.*, 732 F.2d 480, 485 (5th Cir. 1984). Other illustrative cases include *Larese v. Creamland Dairies, Inc.*, 767 F.2d 716, 717 (10th Cir. 1985); *Schneck v. Burger King Corp.*, 756 F. Supp. 543 (S.D.Fla. 1991) *motion to reconsider denied*, 759 F. Supp. 692 (S.D.Fla. 1992); *Shell Oil Co. v. Marinello*, 294 A.2d (N.J.Super.Ct. 1972), *modified*, 307 A.2d 598 (N.J. 1973), *cert. denied*, 415 U.S. 920 (1974).

Proper application of the appropriate legal standard should result in validation of the Act. There is clearly a public purpose involved here, and the Act is rationally related to it, so that the second and third prongs of the legal standard are satisfied. Moreover, the Act applies to all franchisors and does not single out any one particular

franchisor for special treatment. It is those kinds of statutes – those that directly repudiate a specific contract – that are really the ones that the Contract Clause is designed to invalidate. *See, e.g., Energy Reserves,* 459 U.S. at 417 n.25, which distinguishes a constitutionally infirm statute as being one where "a small number of employers were singled out from the larger group." This "favoritism" to a subgroup of a regulated group is what constitutes prohibited "special interest legislation," not the existence of regulation in the first place, and this favoritism is totally absent in the present case.

The decision of the Eighth Circuit conflicts with decisions of other federal courts of appeal which have upheld the retroactive application of legislation affecting existing contracts based on the existence of a public interest. *See e.g., Troy Ltd. v. Renna,* 727 F.2d 287 (3rd Cir. 1984) (upholding the Senior Citizens and Disabled Protected Tenancy Act, which restricted the rights of landlords to evict certain tenants). More specifically, the decision of the Eighth Circuit conflicts with other decisions which uphold retroactive application of laws affecting a franchisor-franchisee relationship. Such cases include *Schieffelin & Co. v. Dep't of Liquor Control,* 479 A.2d 1191 (Conn. 1984); *Anderson's Vehicle Sales, Inc. v. OMC-Lincoln,* 287 N.W.2d 247 (Mich. 1979). Conflicting decisions among federal courts and state courts of last resort on issues of constitutional dimension and impacting upon policy matters of national importance merit review of this matter by this Court.

III. THE DECISION OF THE EIGHTH CIRCUIT COURT OF APPEALS, INVALIDATING THE APPLICATION OF SPECIFIC PROVISIONS OF THE IOWA FRANCHISE ACT TO EXISTING AGREEMENTS ABSENT ANY CONSIDERATION OF THE PRECISE NATURE OF THE CONTRACTUAL RIGHTS INVOLVED AND THE EXTENT TO WHICH THOSE RIGHTS HAD BEEN IMPAIRED, IS CONTRARY TO DECISIONS OF THIS COURT AND INAPPROPRIATELY INVADES THE PROVINCE OF THE STATE LEGISLATURE.

Contract Clause analysis developed by this Court first asks the threshold question of "whether the state law has, in fact, operated as a substantial impairment of a contractual relationship." *Energy Reserves*, 459 U.S. at 411. *See also General Motors Group v. Romein*, ___U.S.___, 112 S.Ct. 1105, 1109, 117 L.Ed.2d 328 (1992) ("Generally, we first ask whether the change in state law has 'operated as a substantial impairment of a contractual relationship'.") This Court has made it abundantly clear that an answer to this question begins with an identification of the *precise* contractual right that has been impaired and the nature of the statutory impairment. *Keystone Bituminous Coal Ass'n v. DeBenedictis*, 480 U.S. 470, 502 (1987).

The *Keystone* requirement is an essential element of Contract Clause analysis that cannot be taken lightly no matter how onerous is the task of examining contractual provisions, assessing the precise rights that have been impaired, and identifying the nature of the statutory impairment. This requirement is in keeping with the long-held principle of constitutional law that "a statute does not violate the Contract Clause simply because it

affects, or even totally bars, the performance of contractual obligations entered into before its enactment date." *Exxon Corp. v. Eagerton*, 462 U.S. 176, 190 (1983). Legislative judgment in safeguarding the vital interests of the public should not be interfered with if the right purportedly impaired is one that falls outside the scope of Contract Clause protection or otherwise has not been substantially impaired by the state's statutory scheme. *Id.*

The need to address this threshold question has been reaffirmed in *General Motors*, 112 S.Ct. at 1109-1110, where this Court reaffirmed that Contract Clause analysis begins by asking whether a change in state law has "operated as a substantial impairment of a contractual relationship." This inquiry has three components: 1) whether there is a contractual relationship, 2) whether a change in law impairs that contractual relationship, and 3) whether the impairment is substantial. *Id.* The language focus on *relationship* cannot be used, however, to abandon the need to discern the precise nature of the contractual *right* involved in favor of tempting and exclusive reliance upon the expectations of the parties in determining whether a substantial impairment of a contractual *right* has occurred. This Court in *General Motors*, just like the Court in earlier Contract Clause cases, engaged in a significant evaluation of the contracts in question, their terms, the rights involved, and the extent, if any, to which such rights had been impaired. No less should have occurred here.

The Eighth Circuit's discussion of the substantial impairment issue consisted of little more than a reference to the opinion of the federal district court. *Holiday Inns*, 29 F.3d at 384 ("We do not think that it can be seriously

contested that the retroactive feature of the relevant Iowa legislation substantially impaired the obligations previously owed to the plaintiffs in this case. . . . We therefore do not see that any useful purpose would be served by a re-examination of the applicable legal principles so ably canvassed and applied by the district court.") The district court did, indeed, "canvass" or set forth certain Contract Clause principles and, further, outlined certain aspects of the contracts involved, but that court failed to analyze specific contractual provisions in light of statutory language, the historical regulation of franchising activities, enunciated principles of Iowa common law, or ethical principles of the franchising industry to determine the *precise* nature of the contractual rights involved and whether those rights had, in fact, been substantially impaired. Rather, the district court relied upon the assertions of disappointed expectations of the plaintiffs and concluded from there that contractual rights had been materially altered by the Iowa Franchise Act. *McDonald's Corp.*, 822 F. Supp. at 606.

The Eighth Circuit seemingly accepted the district court's facial conclusions. The decision of the Eighth Circuit, itself, contains no analysis of whether and to what extent the franchisors would, or even want to, engage in conduct allowed by their contracts but prohibited by the Act. By way of example, the Act does not totally restrict the ability of franchisors to terminate or refuse to renew franchise agreements; franchisors can still engage in these acts if good cause exists to do so. Iowa Code §§ 523H.7,.8. A state law that does not totally negate a contractual provision, or one that replaces the provision with a comparable one, does not necessarily substantially impair the

contract. This Court noted as much in *United States Trust Co. v. New Jersey*, 431 U.S. 1, 19 (1977), where, pointing out that a particular law did substantially impair a contract, the Court specifically stated: "nor was the covenant merely modified or replaced by an arguably comparable security provision. Its outright repeal totally eliminated an important security provision and thus impaired the obligation of the State's contract."

Under this Court's analysis, then, a plaintiff in a Contract Clause case is required to demonstrate the extent to which a state law modified its rights under an existing contract. For example, Holiday Inns and McDonald's should be required to demonstrate the extent to which they frequently seek to terminate or refuse to renew a franchise without good cause. Not only have McDonald's and Holiday Inns not provided any such evidence, they have not even alleged that prior to the passage of the Act they were planning to either terminate or refuse to renew the franchise agreements with the franchisee defendants.

The approach to assessment of "substantial impairment" advocated here is consistent with that adopted by the court in *General Offshore Corp. v. Farrelly*, 743 F. Supp. 1177 (D. Virgin Islands 1990), a case involving a statute which limited the right of an employer to fire an employee. The court there noted that while a statute absolutely prohibiting discharge would work a substantial impairment of contract, the statute in that case provided a list of circumstances under which an employer could discharge an employee, and went on to state that the "plaintiff has not given a single legitimate reason for which an employer might wish to fire an employee that is

not covered by the statute, and this Court can think of no significant ones." *Id.* at 1198-99. The court thus engaged in an "incremental" analysis such as is urged here. Because the plaintiff in *General Offshore* could not show that it wished to terminate employees under conditions not specified by the statute, it failed to convince the court that the statute worked a substantial impairment.

The Eighth Circuit approach, finding substantial impairment in the total absence of any such kind of analysis, results in a situation whereby any contractual alteration will, by virtue of that fact alone, be considered substantial "and thus unconstitutional." As previously noted, such an approach has the immediate and unfortunate effect of drastically reducing the ability of a state to pass any sort of remedial legislation that touches upon any abusive or unfair practices that happen to be incorporated into an agreement between two parties regardless of the relative bargaining strength of the parties involved.

Concern on this point is neither academic nor limited to the case at hand. This Court has remained faithful to its threshold requirement that an analysis of the contractual rights involved must occur. *E.g., General Motors,* 112 S.Ct. at 1109-10; *Keystone,* 480 U.S. at 504; *Exxon,* 462 U.S. at 190-94. Legislative enactments are presumed constitutional. Analysis of the impact of challenged statutes upon an existing contract further accords deference to the state's determination of its own policies. In the end, an appropriate evaluation of contractual terms in accordance with Contract Clause principles is essential to maintaining the long-established balance of constitutional rights and states' interests inherent in this analysis.

IV. PROVISIONS OF IOWA'S FRANCHISE ACT GOVERNING TERMINATION, TRANSFER, NONRENEWAL, AND ENCROACHMENT DO NOT SUBSTANTIALLY IMPAIR RIGHTS AND OBLIGATIONS IN EXISTING CONTRACTS SINCE CERTAIN OF THOSE STATUTORY PROVISIONS ARE VIRTUALLY IDENTICAL TO STATE COMMON LAW AND THERE EXISTS A RICH HISTORY OF REGULATORY, COMMON LAW, AND BUSINESS CONCERN OVER THE UNFAIR AND ABUSIVE PRACTICES THE ACT IS DESIGNED TO REGULATE.

This Court has noted that the history of past regulation is a factor that can be relevant in determining whether an alleged impairment is substantial. *Energy Reserves*, 459 U.S. at 411. No party to the lawsuit disputes the fact that the greater the extent of prior regulation in the area that is the subject of the statute, the less likely it is that substantial impairment of an existing contract will be found. In the present case, the existence of franchise legislation in Iowa and in other states, as well as proposed legislation and scholarly commentary over the past few decades calling for legislation, would suggest to a reasonable franchisor that legislation was likely.

Plaintiffs cannot realistically claim to be unaware of the extensive debate raging in the law books and journals over the propriety of enforcement of contractual provisions such as are at issue here. The court in *Schieffelin & Co. v. Dep't of Liquor*, 479 A.2d 1191 (Conn. 1984) found this to be a relevant consideration in determining the extent to which the area of the contract had been previously regulated. "Nor could they have been unaware of the social and economic problems caused by sudden

termination of franchises. During the early 1970's, for example, just cause termination provisions were included in a variety of franchising statutes in Connecticut." *Id.*, 479 A.2d at 1200-1201. Plaintiffs cannot reasonably argue that they were unaware of the possibility of state regulation in an area fraught with the possibility of abuse where these abuses had been the subject of vigorous prior discussion.

In fact, the termination provisions of Holiday Inns' agreements contain language making those agreements subject to applicable local law. The fact that local law is incorporated in the agreements reflects an awareness of the possibility of regulation. *Energy Reserves*, 459 U.S. at 416. Such awareness is further highlighted by established state common law provisions which were essentially codified by the Act, *see Midwest Management Corp. v. Stephens*, 291 N.W.2d 896, 913 (Iowa 1980) (requiring terminaton of subscription agreement based on good faith and fair dealing), as well as the marked similarity of applicable provisions of the Act to the Code of Ethics approved by the International Franchise Association. By way of example, Iowa Code § 523H.8 requires notice and good cause prior to a refusal to renew a franchise in much the same way that ethical principles of that Association require notice and good cause. *See Franchise Self-Regulation*, CCH Business Franchise Guide, No. 156 (Dec. 18, 1992) at 12.

Appropriate examination of identified contractual rights in light of the above would reveal that impairments, if any, caused by the Act were minimal at best. While different reasons would support this finding depending upon the contractual right alleged and the applicable statutory provison, in the end the Iowa Franchise Act

withstands constitutional scrutiny under Contract Clause analysis unequivocably adhered to by this Court.

CONCLUSION

For all of the above reasons, the State of Iowa, Terry E. Branstad, and the Iowa Franchisee Association respectfully request that their Joint Petition for Writ of Certiorari be granted.

BONNIE J. CAMPBELL
Attorney General of Iowa

GORDON E. ALLEN*
Deputy Attorney General

MARK HUNACEK
Assistant Attorney General
Office of the Attorney General
Second Floor
Hoover State Office Bldg.
Des Moines, Iowa 50319
(515) 281-5166
FAX (515) 281-4209

Counsel for Petitioners, State of Iowa and Terry E. Branstad

BRENT R. APPEL*
DICKINSON, MACKAMAN, TYLER & HAGEN
A Professional Corporation
1600 Hub Tower
699 Walnut Street
Des Moines, Iowa 50309
(515) 244-2600
FAX (515) 246-4550

Counsel for Petitioner, Iowa Franchisee Association

*Counsel of Record

EXHIBIT A

UNITED STATES COURT OF APPEALS

FOR THE EIGHTH CIRCUIT

No. 93-2606

Holiday Inns Franchising, Inc., and Holiday Inns, Inc.,

Appellees,

v.

Terry Branstad, Governor of the State of Iowa,

Appellant,

John Q. Hammons and Omaha Hotel, Inc.,

Defendants,

Iowa Franchisee Association,

Intervenor.

Appeals from the United States District Court for the Southern District of Iowa.

No. 93-2607

McDonald's Corporation,

Appellee,

v.

Steven Nelson and Tass Enterprises, Inc.,

Defendants,

State of Iowa,

Appellant,

Iowa Franchisee Association,

Intervenor.

No. 93-2609

McDonald's Corporation,

Appellee,

v.

Steven Nelson and Tass Enterprises, Inc.,

Defendants,

State of Iowa,

Intervenor,

Iowa Franchisee Association,

Appellant.

Holiday Inns Franchising, Inc., and Holiday Inns, Inc.,

Appellees,

v.

Terry Branstad, Governor of the State of Iowa; John Q. Hammons and Omaha Hotel, Inc.,

Defendants,

Iowa Franchisee Association,

Appellant.

Submitted: January 12, 1994

Filed: July 7, 1994

Before BEAM and MORRIS SHEPPARD ARNOLD, Circuit Judges, and STROM,* District Judge.

MORRIS SHEPPARD ARNOLD, Circuit Judge.

These were consolidated actions for summary judgment claiming that application of the Iowa Franchise Act, *see* Iowa Code Ann. §§ 523H.1-523H.17, to existing franchise agreements was unconstitutional under the Contract Clause of both the United States and Iowa Constitutions. Section 2 of the Act expressly extends its effects to existing franchise arrangements. Plaintiffs

* The HONORABLE LYLE E. STROM, Chief Judge, United States District Court for the District of Nebraska, sitting by designation.

pointed to several provisions of the Act that they believed would substantially and thus unconstitutionally impair the obligations owed by their franchisees under their current licensing arrangements. Those provisions concern principally the circumstances under which franchisees can transfer their franchises without the franchisor's consent and the right of the franchisor to terminate or refuse to renew the agreement. The district court, in a detailed and well-considered opinion, held that the retroactive application of these provisions violated both the Iowa and United States Constitutions. This appeal resulted. We affirm the district court.[1]

I.

We do not think that it can be seriously contested that the retroactive feature of the relevant Iowa legislation substantially impaired the obligations previously owed to the plaintiffs in this case, or that this dispute is ripe for adjudication. We therefore do not see that any useful purpose would be served by a re-examination of the applicable legal principles so ably canvassed and applied by the district court.

We do offer, however, some observations on a very troublesome aspect of current Contract-Clause jurisprudence. The Supreme Court has held that in determining whether an impairment is substantial, and thus unconstitutional, a court should take into account whether the kind of contract or relationship that furnishes the subject

---

[1] The Honorable Harold D. Vietor, United States District Judge for the Southern District of Iowa.

matter of the dispute had previously been the subject of regulation. In *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 250 (1978), for instance, the Court said that the relevant inquiry was whether the disputed legislation operated "in an area already subject to state regulation at the time the company's contractual obligations were originally undertaken," or whether, instead, it "invaded an area never before subject to regulation by the State." A later case states the matter a little differently and, perhaps, more narrowly. In *Energy Reserves Group, Inc. v. Kansas Power and Light Co.*, 459 U.S. 400, 411 (1983), the Court indicated that the proper consideration was "whether the industry the complaining party has entered has been regulated in the past." The idea, evidently, is that if the party to the contract who is complaining could have seen it coming, it cannot claim that its expectations were disappointed. To put it in economic terms, a party's evaluation of the possibility of interference is reflected in the negotiated price, and thus the value of performance to it is not reduced, if it can more or less accurately value the risk of that interference. We believe that this is the principle that the Supreme Court is developing in its cases.

We also believe that the appellees here cannot reasonably be said to have had a fair and appreciable warning of an impending intervention into their agreements. It is true, as appellants point out, that other franchise arrangements of at least five different varieties had been regulated previously in Iowa. But what appellants fail to note is that only one of those statutes purported to be retroactive and then not generally so: Its retrospective effect was limited to franchise agreements that had an

indefinite term. *See* Iowa Code Ann. §§ 322F.1-322F.9. The other such statutes either contain no reference to retroactivity or contain express provisions limiting them to prospective application only. (For an example of the latter type, *see* Iowa Code Ann. §§ 323.1-323.14.) Appellants also cite to a plethora of statutes from other jurisdictions that they claim are similar to the one under consideration here. The infirmity in this argument is that almost none of those statutes purports to be retrospective. It is absolutely plain, moreover, that the retrospective application of statutes similar to the one here, and in the circumstances that are present in this case, has almost uniformly been held unconstitutional, and this is a datum on which franchisors are presumably allowed to rely while bargaining and in fixing the prices of their licenses. *See, e.g., Northshore Cycles, Inc. v. Yamaha Motor Corp., U.S.A.*, 919 F.2d 1041 (5th Cir. 1990) (*per curiam*), and *Morgan v. Kemper Insurance Companies*, 754 F.2d 145 (4th Cir. 1985).

We therefore see no merit in appellants' argument that the plaintiffs are chargeable with notice of a reasonable possibility that the legislature would enact Iowa Code Ann. §§ 523H.1-523H.17 and make those sections retroactively applicable to existing franchise contracts.

II.

We therefore affirm the district court.

A true copy.

Attest:

CLERK, U.S. COURT OF APPEALS, EIGHTH CIRCUIT.

EXHIBIT B

IN THE UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF IOWA
CENTRAL DIVISION

McDONALD'S CORPORATION, Plaintiff, v. STEVEN L. NELSON and TASS ENTERPRISES, INC., Defendants, STATE OF IOWA, Intervenor, IOWA FRANCHISEE ASSOCIATION, Intervenor.	*	CIVIL NO. 4-92-70301 MEMORANDUM OPINION, RULINGS, ADJUDICATION, AND § 1292(b) CERTIFICATION (Filed May 14, 1993)

HOLIDAY INNS FRANCHISING, INC., and HOLIDAY INNS, INC., Plaintiffs, v. TERRY BRANSTAD, JOHN Q. HAMMONS, and OMAHA HOTEL, INC., Defendants, IOWA FRANCHISEE ASSOCIATION, Intervenor.	*	CIVIL NO. 4-92-70431 MEMORANDUM OPINION, RULINGS, ADJUDICATION, AND § 1292(b) CERTIFICATION

Plaintiff McDonald's Corporation ("McDonald's") and plaintiffs Holiday Inns Franchising, Inc. and Holiday Inns, Inc. (jointly referred to as "Holiday Inns") bring separate actions for declaratory judgment seeking determinations that the Iowa Franchise Act, House File 2362 (codified at Iowa Code ch. 523H) ("Act"), violates various provisions of the United States and Iowa constitutions.[1] McDonald's and Holiday Inns each move for partial summary judgment[2] on their claims that the Act violates federal and state Contract Clauses, U.S. Const. art. 1, § 10, cl. 1; Iowa Const. art. 1, § 21.[3] Defendants and intervenors in each case resist plaintiffs' motions. Defendant Terry Branstad in the Holiday Inns case, and intervenor State of Iowa in the McDonald's case, filed cross-motions for partial summary judgment. Plaintiffs resist the cross-motions. The court heard oral arguments, and all the motions are submitted.

SUMMARY JUDGMENT STANDARD

Rule 56 of the Federal Rules of Civil Procedure provides that summary judgment "shall be rendered forthwith if the

---

[1] Plaintiffs claim, *inter alia*, impairment of contracts, denial of procedural and substantive due process, denial of equal protection, and discrimination against and undue burden on interstate commerce.

[2] Although McDonald's calls its motion a motion for summary judgment, it is more accurately called a motion for *partial* summary judgment because it is addressed only to the contract clause claims.

[3] On October 13, 1992, this court declined to consolidate these two cases, but because of the common legal issues in the motions, the court decided to hear the motions for summary judgment together.

pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c). To preclude the entry of summary judgment, the nonmovant must make a sufficient showing on every essential element of its case for which it has the burden of proof at trial. *Celotex Corp v. Catrett*, 477 U.S. 317, 322-23 (1986); *Continental Grain Co. v. Frank Seitzinger Storage, Inc.*, 837 F.2d 836, 838 (8th Cir. 1988). The nonmoving party must go beyond the pleadings and by affidavits, or by the depositions, answers to interrogatories, and admissions on file, designate "specific facts showing that there is a genuine issue for trial." Fed. R. Civ. P. 56(e); *Celotex*, 477 U.S. at 324; *Johnson v. Schopf*, 669 F. Supp. 291, 295 (D. Minn. 1987). The quantum of proof that the nonmoving party must produce is not precisely measurable, but it must be "enough evidence so that a reasonable jury could return a verdict for the nonmovant." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 257 (1986); *Johnson*, 669 F. Supp. at 295-96.

On a motion for summary judgment, the court views all the facts in the light most favorable to the nonmoving party, and gives that party the benefit of all reasonable inferences that can be drawn from the facts. *United States v. City of Columbia, Mo.*, 914 F.2d 151, 153 (8th Cir. 1990); *Woodsmith Publishing Co. v. Meredith Corp.*, 904 F.2d 1244, 1247 (8th Cir. 1990).

BACKGROUND FACTS

The following facts are undisputed. From 1974 to 1982, McDonald's entered into license agreements with

Arch Madden for six McDonald's restaurants in central Iowa. The license agreements run for the following terms: (1) Ankeny, December 1974 to December 1994; (2) S.E. 14th, December 1974 to December 1994; (3) S.W. 9th, April 1979 to April 1999; (4) Altoona, February 1980 to February 2000; (5) Indianola, May 1981 to May 2001; and (6) E. 14th, November 1982 to October 2002. Defendant Steve Nelson acquired the rights to all of the above license agreements in July 1990 and March 1991; each franchise agreement has been assigned to defendant Tass Enterprises, Inc. (Nelson continues to be personally liable for the obligations).

Holiday Inns has two license agreements with defendant Omaha Hotel, Inc. One of the agreements, for a hotel in Davenport, is dated August 26, 1982, and has a termination date of August 8, 1996; the other agreement, dated July 2, 1984, is for a hotel in Council Bluffs, and has a termination date of August 14, 1995. Holiday Inns also has a license agreement with defendant John Q. Hammons for a hotel in Des Moines; that agreement is dated December 30, 1986, and has a termination date of December 29, 2006.

The Iowa Legislature convened the Franchise Regulation Interim Study Committee in 1991 to examine whether franchises in Iowa needed to be regulated, and if so, what that regulation would be. The Study Committee, composed of members of both the House and Senate, met on September 27, 1991, and November 1, 1991. The Committee heard testimony and received reports from franchisors, franchisees, experts, and other interested individuals and entities. In January 1992, the Committee issued its final report containing its recommendations for

legislation. After debate and compromise, the final version of the Act was passed on a 90 to 8 vote in the House and a 40 to 5 vote in the Senate. Governor Terry Branstad signed the bill on April 23, 1992. The Act became effective on July 1, 1992.[4]

INTRODUCTION

In their motions, McDonald's and Holiday Inns challenge, as violative of federal and state Contract Clauses, several sections of the Act in particular: Section 2, which makes the Act applicable to existing franchises operating in the state of Iowa; Section 5, governing transfers of franchises; Section 6, providing guidelines for new franchise encroachment on existing franchises; Section 7, regarding termination (only Holiday Inns specifically argues this section); and Section 8, on nonrenewal of franchises.

First, the court will set out the challenged statutory provisions, the contractual provisions alleged to be impaired, and plaintiffs' contentions as to the nature of the impairment. Next, the court will address two preliminary legal issues, ripeness and the Eleventh Amendment. The final section of the opinion will examine the issues presented under the Contract Clause.

---

[4] Additional undisputed facts are discussed in other sections of the opinion.

STATUTORY AND CONTRACTUAL PROVISIONS

I. Transfer of Franchise

A. Section 5 of the Act

Section 5 provides that a franchisee may transfer the franchise if the transferee satisfies the "reasonable current qualifications" (qualifications based upon legitimate business reasons) of the franchisor for new franchisees. If the proposed transferee does not meet the franchisor's qualifications, the franchisor may refuse to permit the transfer, as long as the franchisor's refusal "is not arbitrary or capricious when compared to the actions of the franchisor in other similar circumstances." Iowa Code § 523H.5(1). Holiday Inns challenges subsections (1), (4), (5), and (13)(d), (e), and (f); McDonald's challenges subsections (4) and (13)(d), (f), and (g).

Subsection (4) states that a "franchisor shall not withhold consent to a franchisee making a public offering of the franchisee's securities without good cause, provided the franchisee or the owners of the franchise retain control of more than fifty percent of the voting power in the franchise."

Subsection (5) states that a "franchisee may transfer the franchisee's interest in the franchise, for the unexpired term of the franchise agreement, and a franchisor shall not require the franchisee or the transferee to enter into a new or different franchise agreement as a condition of the transfer."

Subsection (13) provides that certain occurrences shall not be considered transfers requiring the consent of the franchisor. These occurrences include a "transfer

within an existing ownership group of a franchise (13(d)); a "transfer of less than a controlling interest in the franchise to the franchisee's spouse or child or children (13(e)); and a "transfer of less than a controlling interest in the franchise of an employee stock ownership plan, or employee incentive plan (13(f)); all with the proviso that more than fifty percent of the entire franchise is held by those who meet the franchisor's reasonable current qualifications for franchisees. Under each of these subsections, if less than fifty percent of the franchise would be owned by persons who meet the franchisor's qualifications, "the franchisor may refuse to authorize the transfer," as long as the enforcement of the qualifications is not "arbitrary or capricious when compared to actions of the franchisor in other similar circumstances." The occurrence in 13(g), which is also an occurrence not considered a transfer requiring franchisor consent, is a

> grant or retention of a security interest in the franchised business or its assets, or an ownership interest in the franchisee, provided the security agreement establishes an obligation on the part of the secured party enforceable by the franchisor to give the franchisor notice of the secured party's intent to foreclose on the collateral simultaneously with notice to the franchisee, and a reasonable opportunity to redeem the interest of the secured party and recover the secured party's interest in the franchise or franchised business by paying the secured obligation.

B. McDonald's

Paragraph 15 of the McDonald's license agreement states that the licensee cannot "assign[ ] or otherwise

transfer[ ] in whole or in part" its interest in the license without the prior consent of the licensor. Subparagraphs (a) and (b) provide for assignment to family members in the case of death or permanent incapacity of the licensee, and assignment to wholly-owned corporations of the licensee. Subparagraph (c) provides the licensor with a first option to purchase the license after notice of licensee's intent to sell or transfer the license. Subparagraph (d) states that in addition to the assignments in subparagraphs (a) and (b), the licensee "shall not sell, transfer or assign this License to any person or persons without Licensor's prior written consent. Such consent shall not be arbitrarily withheld." Under subparagraph (d), the licensor considers several criteria in determining whether to grant consent, including work experience and aptitude, financial background, character, ability to devote full time to the restaurant, residence in locality of restaurant, equity interest in restaurant, conflicting interests, and other criteria and conditions then considered for applications for new licenses.

McDonald's argues that because the Act provides franchisees with a variety of transfer rights that pre-existing agreements, like those with defendants, do not allow, the Act is invalid as to pre-existing license agreements.

C. Holiday Inns

Section 12 of the Holiday Inns license agreement sets out many restrictions on transfer of the license. It states that any transfer "not specifically authorized pursuant to this section will be void and will also be a breach of this

agreement. The License may not be the subject of a security interest, lien, levy, attachment or execution." If the licensee wants to transfer the license, the "proposed transferee will, with Licensee's consent, apply for a new license agreement to replace the License for the unexpired term. Licensor will process the application in good faith and in accordance with procedures and criteria * * * then being applied by Licensor in issuing new licenses * * * ."

Section 12 of the agreement also contains provisions allowing transfer of equity interests with the licensor's consent with certain restrictions.

Holiday Inns argues that Section 5 of the Act directly conflicts with its requirement that transferees enter into new license agreements upon transfer, in part because the new agreements often require the transferee to perform reasonable quality upgrades. It also contends that the Act substantially restricts Holiday Inns' rights under existing agreements to control transfers and to select the best qualified individuals or entities as franchisees.

II. Encroachment

A. Section 6 of the Act

Section 6 states that notwithstanding the terms of an agreement or franchise,

> If a franchisor seeks to establish a new outlet, * * * within an unreasonable proximity of an existing franchisee, the existing franchisee, at the option of the franchisor, shall have either a right of first refusal with respect to the proposed

> new outlet, * * * or a right to compensation for market share diverted by the new outlet.

§ 523H.6(1). As applied to a food establishment or food service establishment franchisor, "unreasonable proximity" includes but is not limited to "the shortest distance as measured by the following methods": (a) a "three-mile radius, using a straight line measurement, from the center of an already existing franchise"; (b) a "circular radius, using a straight line measurement, from an existing franchise business which comprises a population of thirty thousand or greater."

Section 6(2) provides for a procedure for right of first refusal. First the parties "seek to establish a mutually agreeable price and terms." If they cannot reach agreement, each party appoints an independent appraiser. If the independent appraisers cannot agree, they name a third appraiser to determine the price and terms. The third appraiser's decision is final and binding, subject to judicial review under Iowa Code chapter 679A. The compensation for the diverted market share is determined by the same process. § 6(3).

B. McDonald's

Paragraph 2(a)(i) of the McDonald's agreement states that McDonald's grants a license to the licensee "to adopt and use the McDonald's System" in the restaurant at only the location specified in the agreement. The licensee acknowledges in paragraph 28(e) that the license establishes a restaurant at the location specified only, and "no 'exclusive,' 'protected' or other territorial rights in the contiguous market area of such Restaurant is hereby

granted or inferred." McDonald's argues that its experience shows that the absence of territorial or exclusive rights for the franchisee serves as an incentive to do more than bare-minimum compliance with the agreement and to avoid material breaches of the agreement.

Also, McDonald's has been planning to develop a new restaurant on Fleur Drive in Des Moines – a site that is within a three-mile radius of Nelson's existing S.W. 9th franchise location. Contrary to existing license agreements, under which McDonald's would be able to determine according to its own practices and policies who should operate the new franchise, the Act provides certain rights to existing franchisees in this situation. Therefore, McDonald's argues, the Act substantially impairs the license agreements.

C. Holiday Inns

Section 1 of the Holiday Inns agreement states that the license is nonexclusive, and "applies to the specified location and no other." It also provides that the agreement "does not limit Licensor's right to use or license the System or to engage in or license any business activity at any other location."

Holiday Inns argues that Section 6 of the Act imposes vague and undue restrictions on the establishment of new franchises or company-owned locations, undermining the concept of a nonexclusive license which is fundamental to its license agreements. It further asserts that the section apparently would apply to establishing franchises of different brands by the same franchisor (e.g., "Holiday Inn"

hotel and a "Holiday Inn Crowne Plaza"), thereby preventing it from serving different market segments of the consuming public in a given area.

III. Termination

A. Section 7 of the Act

Section 7(1) states that "a franchisor shall not terminate a franchise prior to the expiration of its term except for good cause," i.e. "cause based upon a legitimate business reason." Good cause includes a franchisee's failure to "comply with any material lawful requirement of the franchise agreement, provided that the termination by the franchisor is not arbitrary or capricious when compared to the actions of the franchisor in other similar circumstances."

Prior to good cause termination, the franchisor must provide the franchisee with "written notice stating the basis for the proposed termination." § 7(2). After service of the notice, the franchisee "shall have a reasonable period of time to cure the default," no less than 30 days or more than 90 days. *Id.*

Section 7(3) provides a list of situations in which "a franchisor may terminate a franchisee upon written notice and without an opportunity to cure," including: bankruptcy or insolvency of the franchisee or franchise business, voluntary abandonment by the franchisee, mutual agreement by the franchisor and franchisee to terminate, knowing material misrepresentation by the franchisee, the franchisee's repeated failure to comply

with the same material provision of the franchise agreement, lawful seizure or foreclosure by the government, conviction of felony or other criminal misconduct that materially affects the franchise, and operation of the franchise in a manner imminently endangering the public health and safety.

B. Holiday Inns

Section 14 of the Holiday Inns agreement provides that the license will terminate without notice on a specified date (usually for a 20-year term), subject to earlier termination in certain stated situations. Section 14 also provides for liquidated damages for premature termination.

Section 14(b) states that the licensor may terminate with notice if: "(i) the notice is mailed at least 30 days (or longer, if required by law) in advance of the termination date, (ii) the notice reasonably identifies one or more breaches of the Licensee's obligations, and (iii) the breach(es) is/are not fully remedied within the time period specified in the notice." If the notice is the second notice in 12 months about a certain violation for which the default was remedied the first time, the cure period will "if and to the extent permitted by law" be 10 days instead of 30.

The Licensor can immediately (or at the earliest time permitted by applicable law) terminate the licensee upon notice for the following reasons: licensee's insolvency or bankruptcy, licensee's loss of possession of the hotel, licensee's pursuit of a legal contest to the licensor's ownership of the system, a breach of Section 12 (transfer)

occurs, dissolution or liquidation proceedings on a corporate or partnership licensee (except for death of a partner), or "Licensee is, or is discovered to have been, convicted of a felony (or any other offense if it is likely to adversely reflect upon or affect the Hotel, the System or Licensor in any way)."

Holiday Inns argues that the Act's vague requirement of "good cause" should not replace its own well-defined and explicit provisions in its existing agreements. It also asserts that the Act would prohibit it from immediately terminating a franchisee in cases of egregious misconduct.

IV. Nonrenewal of a Franchise

A. Section 8 of the Act

A franchisor cannot refuse to renew a franchise unless: (1) the franchisor notifies the franchisee of its intent not to renew "at least six months prior to the expiration date of the franchise agreement"; *and* (2) good cause exists as defined in section 7 (and the refusal not to renew is not arbitrary or capricious compared to franchisor actions in similar circumstances), *or* the franchisor and franchisee agree not to renew the franchise (provided that the franchisor agrees not to enforce any covenant not to compete with the franchisor or its franchisees when the franchise expires), *or* the "franchisor completely withdraws from directly or indirectly distributing its products or services in the geographic market served by the franchisee" (provided that the franchisor agrees not to enforce any covenant not to compete with the franchisor or its franchisees).

B. McDonald's

All of the McDonald's license agreements at issue are for specific 20-year terms. The licensee acknowledges in paragraph 28(a) that the license is issued for the term stated "with no promise or representation as to the renewal of this License or the grant of a new License." McDonald's follows its own procedure for determining whether to re-write a license agreement, which it has found served as an incentive to "maximize franchisee performance and dedication." McDonald's Brief, p. 25. McDonald's argues that the Act, because it restricts the right of the franchisor to refuse to renew a franchise, contravenes the parties' existing agreements.

C. Holiday Inns

The Holiday Inns license agreements are for stated terms, and terminate without notice on the specified termination date. Section 15 of the agreements governs renewals. The licensee can apply for a "commitment to renew the License" during a certain year of the term (the 15th year for 20-year terms). The licensor promises to process the application in good faith and in accordance with procedures and criteria applicable to new license applications at the time. If the licensor approves the application, the parties sign two agreements: "A new license agreement covering the unexpired License Term under this agreement, and a commitment agreement to renew the License Term, upon expiration, for a specified time (up to 10 years) if Licensee fulfills specified upgrading and other requirements within a specified time."

Holiday Inns argues that the Act substantially impairs its agreements by effectively requiring Holiday Inns to grant a franchise of perpetual duration at the option of the franchisee, even though the franchisee paid only for a specified term. Holiday Inns also argues that the Section 6 of the Act disserves the public by preventing Holiday Inns from replacing marginal hotel operators at the end of a term, and from responding to changing market conditions by replacing inappropriate hotel locations.

RIPENESS

Certain defendants and intervenors argue that the issues in these cases, at least as applied to plaintiffs' specific license agreements, are not ripe for judicial determination. To fit within the constitutional limit on federal court jurisdiction to "cases and controversies," U.S. Const. art. III, § 2, "the controversy must be definite and concrete and not of a hypothetical or abstract character." *Oil, Chemical & Atomic Workers Int'l Union, AFL-CIO v. Gillette Co.*, 905 F.2d 1176, 1177 (8th Cir. 1990); *see also Aetna Life Ins. Co. v. Haworth*, 300 U.S. 227, 240-41 (1937). "The ripeness doctrine is invoked to determine whether a dispute has yet matured to a point that warrants decision. The determination is rested both on Article III concepts and on discretionary reasons of policy." *Automotive, Petroleum & Allied Indus. Employees Union, Local 618 v. Gelco Corp.*, 758 F.2d 1272, 1275 (8th Cir. 1985) (citation omitted). The "question of ripeness turns on 'the fitness of the issues for judicial decision' and 'the hardship to the parties of withholding court consideration.' " *Pacific Gas & Elec. Co. v. State Energy Resources Conservation & Dev.*

Comm'n, 461 U.S. 190, 201 (1983); *see also Abbott Labs. v. Gardner*, 387 U.S. 136, 149 (1967), *overruled on other grounds, Califano v. Sanders*, 430 U.S. 99, 105 (1977); *Gelco Corp.*, 758 F.2d at 1275.

In determining whether the issues are fit for consideration, courts look at numerous factors, including the adverseness of the parties, whether the legal issues would be affected by further factual development, judicial efficiency, finality, and the likelihood that the asserted injury or anticipated events will occur. *See Allstate Ins. Co. v. Wayne County*, 760 F.2d 689, 696 (6th Cir. 1985) (citing various cases).

Here, the defendants and interveners are sufficiently adverse to plaintiffs; the parties are contesting vigorously the issue of the constitutionality of the Act as applied to existing license agreements between plaintiffs and defendants. Because plaintiffs request a declaration that the Act's provisions in and of themselves conflict with their rights under their license agreements, further factual development is unnecessary.

The anticipated events are likely to occur. Some of the license agreements are approaching their termination dates; this certainly implicates the termination and nonrenewal provisions of the Act. The encroachment provisions of the Act affect the parties to the agreements not only when the final steps are taken to acquire land for a new franchise within an "unreasonable proximity" to an existing franchisee, but also at the planning and development stages when a decision has to be made whether and where to open a new franchise. The transfer provisions

change the franchisor consent requirements and the conditions under which some transfers can occur. Although the parties could await a situation where a current franchisee attempts to transfer within the terms of the statute but in violation of the franchisee's license agreement, this court will be in no better position later than now to decide the question of whether the Act's transfer and other provisions unconstitutionally impair plaintiffs' contract rights. *Cf. Duke Power Co. v. Carolina Envtl. Study Group, Inc.*, 438 U.S. 59, 81 (1978); *Bob's Home Service, Inc. v. Warren County*, 755 F.2d 625, 628 (8th Cir. 1985). The issues, therefore, are fit for judicial decision.

Furthermore, the uncertainty of which provisions to follow – the Act's or the license agreements' – constitutes hardship to the parties if this court withholds consideration of the constitutional issues under the Contract Clause. Plaintiffs (and for that matter their franchisees) should not be forced to act at their peril before a determination of these issues. This court concludes that the constitutional issues presented under the Contract Clause are ripe for adjudication.

ELEVENTH AMENDMENT

Defendant Branstad in the Holiday Inns case and intervenor State of Iowa in the McDonald's case argue that "the Eleventh Amendment deprives this court of jurisdiction to issue declarative or injunctive relief against the state based on alleged violations of state law," citing *Pennhurst State School & Hosp. v. Halderman*, 465 U.S. 89 (1984). The Eleventh Amendment, however, is not implicated in these cases because neither McDonald's nor

Holiday Inns seeks relief against Branstad or the state (and in McDonald's the state is merely an intervenor, not a defendant). Rather, plaintiffs seek a declaration that the Act, as applicable to plaintiffs' existing license agreements with the franchisee defendants, is unconstitutional under the federal and state Contract Clauses. The Eleventh Amendment does not deprive this court of jurisdiction.

CONTRACT CLAUSE

The federal Contract Clause provides that "[n]o State shall * * * pass any * * * Law impairing the Obligation of Contracts * * * ." U.S. Const. art. 1, § 10, cl. 1. The Iowa Contract Clause[5] uses language substantially similar to the federal clause, and the constitutional analysis is substantially the same, *see Adair Benev. Soc. v. State, Ins. Div.*, 489 N.W.2d 1, 5 (Iowa 1992).

I. Substantial Impairment

The threshold inquiry under the Contract Clause is whether the Iowa Franchise Act "has, in fact, operated as a substantial impairment of a contractual relationship." *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 244 (1978); *see also Energy Reserves Group v. Kansas Power & Light Co.*, 459 U.S. 400, 411 (1983).

---

[5] "No * * * law impairing the obligation of contracts, shall ever be passed." Iowa Const. art. 1, § 21.

> The severity of the impairment is said to increase the level of scrutiny to which the legislation will be subjected. Total destruction of contractual expectations is not necessary for a finding of substantial impairment. On the other hand, state regulation that restricts a party to gains it reasonably expected from the contract does not necessarily constitute a substantial impairment.

Energy Reserves, 459 U.S. at 411 (citations omitted). Under this inquiry, the court must "identify the precise contractual right that has been impaired and the nature of the statutory impairment." *Keystone Bituminous Coal Ass'n v. DeBenedictus*, 480 U.S. 470, 504 (1987).

The undisputed facts in both cases' summary judgment records clearly establish that the parties executed the license agreements at issue with certain expectations, including that the agreements applied to only certain franchise locations and for certain terms (many for 20 years), restricted transfer rights, included certain provisions for early termination, did not promise renewal, and contained no territorial rights. For plaintiffs, these expectations played an integral role in the pricing of the licenses, and continue to be important in the successful operation of each franchise and in the operation of plaintiffs' respective franchising systems in general. Plaintiffs assert that the rights they retained in their license agreements operate as an incentive for franchisees to maximize their performance; allow plaintiffs to change with current market conditions; and serve the consuming public by maintaining adequate control over the quality of services provided under their licensed trademarks.

For these reasons, the court concludes that the Iowa Franchise Act materially changes the rights to which the parties agreed and for which they gave consideration. *Cf. Birkenwald Dist. Co. v. Heublein, Inc.*, 776 P.2d 721 (Wash. Ct. App. 1989); *Jacobsen v. Anheuser-Busch, Inc.*, 392 N.W.2d 868, 874 (Minn. 1986), *cert. denied*, 479 U.S. 1060 (1987); *Ward v. Chevron U.S.A. Inc.*, 598 P.2d 1027 (Ariz. Ct. App. 1979); *Globe Liquor Co. v. Four Roses Distillers Co.*, 281 A.2d 19 (Del.), *cert. denied*, 404 U.S. 873 (1971).

"In determining the extent of the impairment," the court must "consider whether the industry the complaining party has entered has been regulated in the past." *Energy Reserves*, 459 U.S. at 411 (citations omitted). The court believes that the "industries" involved in these cases are the hotel[6] and food service industries. *See, e.g., Exxon Corp. v. Eagerton*, 462 U.S. 176, 194-95 n.14 (1983) (oil industry); *Energy Reserves*, 459 U.S. at 413 (natural gas industry); *Veix v. Sixth Ward Bldg. & Loan Ass'n*, 310 U.S. 32, 38 (1940) (building and loan association "enterprise"). State regulation of the hotel and food service industries prior to the Iowa Franchise Act focused mainly on the delivery of services to the customer, including safety and health concerns, *see, e.g.*, Iowa Code chs. 137B (food service), 137C (hotel), and discrimination against employees or customers, *see* Iowa Code §§ 216.6, 216.7 (formerly §§ 601A.6, 601A.7). The Act, which focuses on the business relationships between franchisors and franchisees, is

---

[6] The court uses the phrase "hotel industry" in a more generic sense to include hotels, motels, inns, and other similar travel accommodations.

much different from the type of regulation existing at the time the Act became effective.

Defendants and intervenors identify the relevant industry as the "franchise industry," and argue that plaintiffs reasonably could and should have expected that franchising in Iowa would be subject to additional regulation because of past regulation of certain franchise relationships in Iowa and in several other states. It is doubtful that franchising is an "industry" within the meaning of that word as used in *Energy Reserves* and other cases, or as defined generally.[7] The Court in *Allied Structural Steel*, however, when faced with a statute involving pension plan funding, considered whether the act "operate[d] in an *area* already subject to state regulation at the time the company's contractual obligations were originally undertaken," or whether it instead "invaded an *area* never before subject to regulation by the State." 438 U.S. at 250 (emphasis added). This court will therefore consider state regulation in the "area" of franchising at the time the agreements were executed.

Iowa's past regulation of franchising has been confined to franchises involving retailers of certain goods – motor vehicles, agricultural equipment, and moter fuel.

---

[7] "Industry" is defined as "a department or branch of a craft, art, business, or manufacture" and "a group of productive or profit-making enterprises or organizations that have a similar technological structure of production and that produce or supply technically substitutable goods, services, or sources of income." *Webster's Third New International Dictionary* 1155-56 (Merriam-Webster Inc. 1986). Franchising, on the other hand, is a means by which certain business relationships within an industry, and across industries, are formed and implemented.

See Iowa Agricultural Equipment Dealership Agreements Act, ch. 322F (1990); Iowa Farm Implement & Motorcycle Franchises Act, ch. 322D (1985); Iowa Purchasing Fuel from Alternate Sources Act, ch. 323A (1980); Iowa Travel Trailer Dealers, Manufacturers & Distributors Act, ch. 322C (1979); Iowa Marketing & Distribution of Motor Fuel & Special Fuel Act, ch. 323 (1974); Iowa Motor Vehicle Franchisors Act, ch. 322A (1970). In contrast, the Iowa Franchise Act extends to all franchises except those already regulated by state law and those relating to "the sale of construction equipment, lawn or garden equipment, or real estate." § 523H.1(3)(c).

Defendants also point to other states' general franchise statutes. *See, e.g.*, Illinois Franchise Disclosure Act of 1987, Ill. Ann. Stat. ch. 121 1/2 ¶ 1701 *et seq.* (eff. 1/1/88); California Franchise Relations Act, Cal. Bus. & Prof. Code §§ 20000 *et seq.* (eff. 10/1/80; operative 1/1/81); Nebraska Franchise Practices Act, Neb. Rev. Stat. § 87-401 to 87-410 (1978); Arkansas Franchise Practices Act, §§ 4-72-201 *et seq.* (1977); Indiana Deceptive Franchise Practices, Ind. Code Ann. § 23-2-2.7-1 (1975); am. 1985, 1987); South Dakota Franchises for Brand-Name Goods & Services Act, S.D. Codified Laws Ann. §§ 37-5A-1 *et seq.* (1974); Michigan Franchise Investment Law, Mich. Comp. Laws Ann. § 445.1527 (1974; am. 1984); Wisconsin Dealership Practices Act, ch. 135 (1974); Minnesota Franchise Act, Minn. Stat. Ann. ch. 80C (1973; am. 1987); Virginia Retail Franchising Act, Va. Code Ann. §§ 13.1-557 *et seq.* (1972); Wisconsin Franchise Investment Law, Wisc. Stat. Ann. ch. 553 (1972); Washington Franchise Investment Protection Act. Wash. Rev. Code Ann. §§ 19.100.180 – 19.100.190 (eff. 1972; am. 1973, 1980, 1991);

New Jersey Franchise Practices Act, N.J. Stat. Ann. §§ 56:10-1 to 10-12 (1971). This court doubts that regulation in one state or even several states accurately forecasts what another state will regulate. Defendants assert that looking to regulation in other states is proper because the Court in *Energy Reserves* mentions by way of footnote that the natural gas industry is heavily regulated, citing regulation by a majority of states and the federal government. *See* 459 U.S. at 413 n.15. In the discussion about prior regulation in the body of the opinion, however, the Court looks at the nature of natural gas regulation in Kansas specifically. *Id.* at 413-14.

Even if this court did consider other states' legislation, it would not provide support to defendants: those statutes were not as comprehensive as the Iowa Act; most, if not all, were only prospective in nature (or have been applied as such); and most were enacted after the parties executed at least some of the McDonald's license agreements. Even at the time of execution of the Holiday Inns agreements in the 1980s and assignment of the McDonald's agreements in 1990 and 1991, only a minority of states had enacted general franchise regulation. Therefore, I conclude that prior regulation in Iowa and other states at the time of the execution and assignment of the license agreements was not sufficient to put plaintiffs on notice that they would be subject to later regulation of the type contained in the Act.

This court concludes that the retroactive application of Iowa Code §§ 523H.5(4), (5), (13)(d), (f), and (g); 523H.6; and 523H.8 to McDonald's license agreements, and §§ 523H.5(3), (4), (5), (13)(d), (e), and (f); 523H.6; 523H.7; and 523H.8 to Holiday Inns license agreements,

substantially impairs the parties' contractual rights in the agreements in existence at the time the Act became effective.

II. Public Purpose

If the Act constitutes a substantial impairment, the state of Iowa must then show a "significant and legitimate public purpose behind the regulation" to justify it, "such as the remedying of a broad and general social or economic problem." *Energy Reserves,* 459 U.S. at 411-12. "The requirement of a legitimate public purpose guarantees that the State is exercising its police power, rather than providing a benefit to special interests." *Id.* at 412. The police power " 'is an exercise of the sovereign right of the Government to protect the lives, health, morals, comfort and general welfare of the people, and is paramount to any rights under contracts between individuals.' " *Allied Structural Steel,* 438 U.S. at 241 (quoting *Manigault v. Springs,* 199 U.S. 473, 480 (1905)).

Senator Mike Gronstal, president of the Iowa Senate and a member of the Study Committee, filed an affidavit which states the following. The Iowa Legislature, through the Study Committee, undertook significant study of franchising to determine the areas in which legislation might be appropriate. The Committee found that some franchisors have engaged in abusive and unfair practices in relation to their franchisees.[8] The Committee heard

---

[8] For instance, one Iowa franchisee spoke of the franchisor forcing him to sign, by threat and intimidation, a significantly different agreement several years before the end of his existing

testimony that franchising is an important part of Iowa's economy, that franchising as a way of business has been growing; and that the unfair practices of some franchisors can harm Iowa franchises, consumers, and other businesses. On this basis, the Study Committee recommended legislation in several areas. The bill went through several drafts, with changes made after consultation with franchisors.

A review of the summary judgment record shows that the major purposes of the Act, as articulated by proponents during the hearings, were the equalization of bargaining power, the promotion of fair dealing, and the protection of franchisees from fraudulent and abusive practices by franchisors. Proponents also asserted that the government's role is to ensure a fair market and fair business practices between franchisees and franchisors. The Committee hearings in large part focused on specific instances of abuses in Iowa and nearby states by a few national franchisors.[9]

---

agreement. *See* Statement of Fred Miller. A Kansas franchisee spoke of an incident allegedly constituting "tortious interference with business relationships" by the franchisor, but his franchise agreement prohibited him from suing the franchisor. *See* Statement of Joel Grodberg.

The court notes that plaintiffs were not identified as those franchisors who have engaged in abusive practices.

[9] The record indicates, however, that others who wanted to appear and present statements did not out of fear of repercussions by their franchisors. *See, e.g.*, Committee Minutes, Nov. 1, 1991, p. 10 (comment of Co-Chair Hansen); Statement of Bob Schlutz.

Additionally, some franchisees spoke against the bill, fearing its effect on the good relationships they have with their

An important factor in the cases that have upheld the validity of legislation challenged under the Contract Clause is that the laws "did not prescribe a rule limited in effect to contractual obligations or remedies, but instead imposed a generally applicable rule of conduct designed to advance 'a broad societal interest' * * * ." *Exxon,* 462 U.S. at 191 (citation omitted); *see also Ross v. City of Berkeley,* 655 F. Supp. 820, 832-33 (N.D. Cal. 1987). The Court in *Exxon* distinguished the laws described above from those held invalid in *United States Trust Co. v. New Jersey,* 431 U.S. 1 (1977), and *Allied Structural Steel,* which " 'directly adjusted the rights and responsibilities of contracting parties.' " *Exxon,* 462 U.S. at 192; *Ross,* 655 F. Supp. at 833.

Here, the articulated overall purpose of the Act is specifically to adjust the balance of power between contracting parties. Although defendants and intervenors urge that franchising is a growing practice and a growing part of the economy in Iowa and throughout the nation, that fact by itself does not supply a broad societal interest justifying the substantial impairment of *existing* contracts. Nor have defendants and intervenors identified any other broad societal interest that the Act furthers. The state asserts that the unfair practices of some franchisors can harm consumers and other businesses, but it has not

---

franchisors and on the quality of the particular franchising systems in which they operate. Some speakers related the perceived burdens the regulation would place on large and small franchisors alike. A few speakers noted that the vast majority of franchisors operate in good faith.

described the harm sufficiently for purposes of Contract Clause analysis.

This court finds and concludes that the Act is not based on a significant and legitimate public purpose such as a "broad and general social or economic problem" sufficient to justify the substantial impairment that some of its provisions have on plaintiffs' license agreements in existence on the Act's effective date.[10] Analysis under the last step in Contract Clause analysis is therefore unnecessary, and plaintiffs' motions for summary judgment will be granted.

RULINGS AND ADJUDICATIONS

The motion for summary judgment by plaintiff McDonald's Corporation in Civ. No. 4-92-70301, filed on September 18, 1992, is GRANTED. The cross-motion for partial summary judgment by intervenor State of Iowa in Civ. No. 4-92-70301, filed on November 16, 1992, is DENIED.

The motion for partial summary judgment by plaintiffs Holiday Inns Franchising, Inc. and Holiday Inns, Inc. in Civ. No. 4-92-70431, filed on October 23, 1992, is GRANTED. The cross-motion for partial summary judgment by defendant Terry Branstad in Civ. No. 4-92-70431, filed on November 16, 1992, is DENIED.

---

[10] This court, of course, expresses no opinion on the constitutionality of the Act as applied to contracts entered into or renewed *after* the effective date of the Act.

IT IS ADJUDICATED that Iowa Code sections 523H.5(4), (5), (13)(d), (f), and (g); 523H.6; and 523H.8 substantially impair, in violation of the Contract Clauses of the United States Constitution and the Iowa Constitution, plaintiff McDonald's contractual rights under its license agreements with defendants Steven Nelson and Tass Enterprises, Inc., described in the Background Facts section of this Memorandum Opinion.

IT IS FURTHER ADJUDICATED that Iowa Code sections 523H.5(1), (4), (5), (13)(d), (e), and (f); 523H.6; 523H.7; and 523H.8 substantially impair, in violation of the Contract Clauses of the United States Constitution and the Iowa Constitution, plaintiff Holiday Inns' contractual rights under its license agreements with defendants John Q. Hammons and Omaha Hotel, Inc., described in the Background Facts section of this Memorandum Opinion.

§ 1292(b) CERTIFICATION

Pursuant to 28 U.S.C. § 1292(b), I certify that I am of the opinion that the foregoing adjudications involve a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the adjudications may materially advance the ultimate termination of the litigation.

Dated this 14th day of May, 1993.

EXHIBIT C

523H.6 Transfer of Franchise.

1. A franchisee may transfer the franchised business and franchise to a transferee, provided that the transferee satisfies the reasonable current qualifications of the franchisor for new franchisees. For the purposes of this section, a reasonable current qualification for a new franchisee is a qualification based upon a legitimate business reason. If the proposed transferee does not meet the reasonable current qualifications of the franchisor, the franchisor may refuse to permit the transfer, provided that the refusal of the franchisor to consent to the transfer is not arbitrary or capricious when compared to the actions of the franchisor in other similar circumstances.

2. Except as otherwise provided in this section, a franchisor may exercise a right of first refusal contained in a franchise agreement after receipt of a proposal from the franchisee to transfer the franchise.

3. A franchisor may require as a condition of a transfer any of the following:

a. That the transferee successfully complete a reasonable training program.

b. That a reasonable transfer fee be paid to reimburse the franchisor for the franchisor's reasonable and actual expenses directly attributable to the transfer.

c. That the franchisee pay or make provision reasonably acceptable to the franchisor to pay any amount due the franchisor or the franchisor's affiliate.

4. A franchisor shall not withhold consent to a franchisee making a public offering of the franchisee's securities without good cause, provided the franchisee or the

owners of the franchise retain control of more than fifty percent of the voting power in the franchise.

5. A franchisee may transfer the franchisee's interest in the franchise, for the unexpired terms of the franchise agreement, and a franchisor shall not require the franchisee or the transferee to enter into a new or different franchise agreement as a condition of the transfer.

6. A franchisee shall give the franchisor no less than sixty days' written notice of a transfer which is subject to the provisions of this section, and on request from the franchisor shall provide in writing the ownership interests of all persons holding or claiming an equitable or beneficial interest in the franchise subsequent to the transfer or the franchisee, as appropriate. A franchisee shall not circumvent the intended effect of a contractual provision governing the transfer of the franchise or an interest in the franchise by means of a management agreement, lease, profit-sharing agreement, conditional assignment, or other similar device.

7. A franchisor shall not transfer its interest in a franchise unless the franchisor makes reasonable provision for the performance of the franchisor's obligations under the franchise agreement by the transferee. A franchisor shall provide the franchisee notice of a proposed transfer of the franchisor's interest in the franchise at the time the disclosure is required of the franchisor under applicable securities laws, if interests in the franchisor are publicly traded, or if not publicly traded, at the time such disclosure would be required if the interests in the franchisor were publicly traded.

8. A transfer by a franchisor is deemed to be approved sixty days after the franchisee submits the request for consent to the transfer unless the franchisor withholds consent to the transfer as evidenced in writing, specifying the reason or reasons for withholding the consent. The written notice must be delivered to the franchisee prior to the expiration of the sixty-day period. Any such notice is privileged and is not actionable based upon a claim of defamation.

9. A franchisor shall not discriminate against a proposed transferee of a franchise on the basis of race, color, national origin, sex, or physical handicap.

10. A franchisor, as a condition to a transfer of a franchise, shall not obligate a franchisee to undertake obligations or relinquish any rights unrelated to the franchise proposed to be transferred, or to enter into a release of claims broader than a similar release of claims by the franchisor against the franchisee which is entered into by the franchisor.

11. A franchisor, after a transfer of a franchise, shall not seek to enforce any covenant of the transferred franchise against the transferor which prohibits the transferor from engaging in any lawful occupation or enterprise. However, this subsection does not prohibit the franchisor from enforcing a contractual covenant against the transferor not to exploit the franchisor's trade secrets or intellectual property rights, unless otherwise agreed to by the parties.

12. For purposes of this section, "*transfer*" means any change in ownership or control of a franchise, franchised business, or a franchisee.

13. The following occurrences shall not be considered transfers requiring the consent of the franchisor under a franchise agreement, and shall not result in the imposition of any penalties or make applicable any right of first refusal by the franchisor:

a. The succession of ownership of a franchise upon the death or disability of a franchisee, or of an owner of a franchise, to the franchisee's spouse, child or children, or a partner of the franchisee unless the successor fails to meet the then current reasonable qualifications of the franchisor for franchisees and the enforcement of the reasonable current qualifications is not arbitrary or capricious when compared to actions of the franchisor in other similar circumstances.

b. The succession of a spouse, child, partner, or other owner as operating manager upon the death or disability of the operating manager, unless the successor fails to meet the then current reasonable qualifications of the franchisor for an operating manager, and enforcement of the reasonable current qualifications is not arbitrary or capricious when compared to actions of the franchisor in other similar circumstances.

c. Incorporation of a proprietorship franchisee, provided that such incorporation does not prohibit a franchisor from requiring a personal guaranty by the franchisee of obligations related to the franchise.

d. A transfer within an existing ownership group of a franchise provided that more than fifty percent of the franchise is held by persons who meet the franchisor's reasonable current qualifications for franchisees. If less than fifty percent of the franchise would be owned by

persons who meet the franchisor's reasonable current qualifications, the franchisor may refuse to authorize the transfer, provided that enforcement of the reasonable current qualifications is not arbitrary or capricious when compared to actions of the franchisor in other similar circumstances.

e. A transfer of less than a controlling interest in the franchise to the franchisee's spouse or child or children, provided that more than fifty percent of the entire franchise is held by those who meet the franchisor's reasonable current qualifications if less than fifty percent of the franchise would be owned by persons who meet the franchisor's reasonable current qualifications, the franchisor may refuse to authorize the transfer, provided that enforcement of the reasonable current qualifications is not arbitrary or capricious when compared to actions of the franchisor in other similar circumstances.

f. A transfer of less than a controlling interest in the franchise of an employee stock ownership plan, or employee incentive plan, provided that more than fifty percent of the entire franchise is held by those who meet the franchisor's reasonable current qualifications for franchises. If less than fifty percent would be owned by persons who meet the franchisor's reasonable current qualifications, the franchisor may refuse to authorize the transfer, provided that enforcement of its reasonable current qualifications is not arbitrary or capricious when compared to actions of the franchisor in other similar circumstances.

g. A grant or retention of a security interest in the franchised business or its assets, or an ownership interest

in the franchisee, provided the security agreement establishes an obligation on the part of the secured party enforceable by the franchisor to give the franchisor notice of the secured party's intent to foreclose on the collateral simultaneously with notice to the franchisee, and a reasonable opportunity to redeem the interests of the secured party and recover the secured party's interest in the franchise or franchised business by paying the secured obligation.

14. A franchisor shall not interfere or attempt to interfere with any disposition of an interest in a franchise or franchised business as described in subsection 13, paragraphs "*a*" through "*g*".

92 Acts, ch 1134, §5

623H.6 Encroachment.

1. Notwithstanding the terms, provisions, or conditions of an agreement or franchise, if a franchisor seeks to establish a new outlet, company-owned store, or carry-out store within an unreasonable proximity of an existing franchisee, the existing franchisee, at the option of the franchisor, shall have either a right of first refusal with respect to the proposed new outlet, company-owned store, or carry-out store or a right to compensation for market share diverted by the new outlet. For the purposes of this section, "*unreasonable proximity*" as applied to a food establishment franchisor or food service establishment franchisor, including outlets and carry-out stores as defined by section 137A.1, subsection 6, and

section 137B.2, subsection 6, includes but is not limited to the shortest distance as measured by the following methods:

a. A three-mile radius, using a straight line measurement, from the center of an already existing franchise.

b. A circular radius, using a straight line measurement, from an existing franchise business which comprises a population of thirty thousand or greater.

2. With respect to a right of first refusal, the parties shall in good faith seek to establish a mutually agreeable price and terms. If the parties are unable to agree, each party shall appoint an independent appraiser. If the independent appraisers are unable to agree upon a price and terms, the independent appraisers shall name a third appraiser to determine the price and terms upon which the right of final refusal may be exercised. The determination of the independent appraiser shall be final and binding, and subject to judicial review under chapter 679A.

If two or more existing franchises are located within an unreasonable proximity to the proposed outlet, the closest franchisee shall have the first right of first refusal, and if declined, the right of first refusal shall pass to the next closest franchisee.

3. If the franchisor does not offer a right of first refusal, the franchisor shall compensate existing franchisees for market share diverted by the opening of the new outlet. If the franchisor and existing franchisees cannot agree upon the proper amount of such compensation, each party shall appoint an independent appraiser. If the

independent appraisers are unable to agree, the independent appraisers shall appoint a third appraiser who shall establish the level of compensation. The determination of the independent appraiser shall be final and binding, and subject to judicial review under chapter 679A.

4. The court may grant a permanent or preliminary injunction to prevent injury or threatened injury from the violation or threatened violation of this section.

92 Acts, ch 1134, §6

523H.7 Termination.

1. Except as otherwise provided by this chapter, a franchisor shall not terminate a franchise prior to the expiration of its term except for good cause. For purposes of this section, *"good cause"* is cause based upon a legitimate business reason. *"Good cause"* includes the failure of the franchisee to comply with any material lawful requirement of the franchise agreement, provided that the termination by the franchisor is not arbitrary or capricious when compared to the actions of the franchisor in other similar circumstances.

2. Prior to termination of a franchise for good cause, a franchisor shall provide a franchisee with written notice stating the basis for the proposed termination. After service of written notice, the franchisee shall have a reasonable period of time to cure the default, which in no event shall be less than thirty days or more than ninety days.

3. Notwithstanding subsection 2, a franchisor may terminate a franchisee upon written notice and without an opportunity to cure if any of the following apply:

a. The franchisee or the business to which the franchise relates is declared bankrupt or judicially determined to be insolvent.

b. The franchisee voluntarily abandons the franchise by failing to operate the business for five consecutive business days during which the franchisee is required to operate the business under the terms of the franchise, or any shorter period after which it is not unreasonable under the facts and circumstances for the franchisor to conclude that the franchisee does not intend to continue to operate the franchise, unless the failure to operate is due to circumstances beyond the control of the franchisee.

c. The franchisor and franchisee agree in writing to terminate the franchise.

d. The franchisee knowingly makes any material misrepresentations or knowingly omits to state any material facts relating to the acquisition or ownership or operation of the franchise business.

e. The franchisee repeatedly fails to comply with the same material provision of a franchise agreement, when the enforcement of the material provision by the franchisor is not arbitrary or capricious when compared to the franchisor in other similar circumstances.

f. The franchised business or business premises of the franchisee are lawfully seized, taken over, or foreclosed by a government authority or official.

g. The franchisee is convicted of a felony or any other criminal misconduct which materially and adversely affects the operation, maintenance, or goodwill of the franchise in the relevant market.

h. The franchisee operates the franchised business in a manner that imminently endangers the public health and safety.

92 Acts, ch 1134, §7

523H.8 Nonrenewal of a franchise.

A franchisor shall not refuse to renew a franchise unless both of the following apply:

1. The franchisee has been notified of the franchisor's intent not to renew at least six months prior to the expiration date or any extension of the franchise agreement.

2. Any of the following circumstances exist:

a. Good cause exists as defined in section 523H.7, provided that the refusal of the franchisor to renew is not arbitrary or capricious when compared to the actions of the franchisor in other similar circumstances.

b. The franchisor and franchisee agree not to renew the franchise, provided that upon the expiration of the franchise, the franchisor agrees not to seek to enforce any covenant of the nonrenewed franchise not to compete with the franchisor or franchisees of the franchisor.

c. The franchisor completely withdraws from directly or indirectly distributing its products or services in the geographic market served by the franchisee, provided that upon expiration of the franchise, the franchisor agrees not to seek to enforce any covenant of the nonrenewed franchisee not to compete with the franchisor or franchisees of the franchisor.

92 Acts, ch 1134, §8

SUPREME COURT, U.S.
FILED
NOV 7 1994
OFFICE OF THE CLERK

No. 94-618

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

STATE OF IOWA, TERRY E. BRANDSTAD, and,
IOWA FRANCHISEE ASSOCIATION

Petitioners,

vs.

HOLIDAY INNS FRANCHISING INC.
HOLIDAY INNS, INC., and
McDONALD'S CORPORATION,

Respondents.

Joint Petition for Writ of Certiorari
To The United States Court of Appeals
For The Eighth Circuit

BRIEF OF McDONALD'S CORPORATION IN OPPOSITION TO CERTIORARI

Of Counsel
ROBERT T. JOSEPH
WILLIAM T. BARKER
JILL A. THOMPSON
SONNENSCHEIN NATH & ROSENTHAL
8000 Sears Tower
233 S. Wacker Drive
Chicago, IL 60606-6404

KIM J. WALKER
FABORE & BENSON
400 Locust Street, #400
Des Moines, IA

ALAN H. SILBERMAN
8000 Sears Tower
233 S. Wacker Drive
Chicago, IL 60606-6404
(312) 876-8000
Counsel of Record for McDonald's Corporation

SHELBY YASTROW
GEORGE T. RUMMEL
McDONALD'S CORPORATION
One McDonald's Plaza
Oak Brook, IL 60521

BEST AVAILABLE COPY

QUESTION PRESENTED

Whether the district court and court of appeals erred in determining, on undisputed facts, that the provisions of the Iowa Franchise Act challenged in the complaint unconstitutionally impair pre-existing franchise agreements when:

(a) those provisions of the Iowa Franchise Act alter fundamental express terms of the agreements (including the nature of the contract and scope of the transaction, the identity of the parties, and the duration of the agreement), which terms were essential to the bargain originally made;

(b) neither Iowa (which previously had no law regulating franchises generally) nor any other state had ever imposed similar retroactive alterations on franchise agreements; and

(c) retroactive application of the challenged provisions served only to redistribute benefits and burdens between the parties to pre-existing franchise agreements, and the public interest asserted as justifying the impairment related solely to the greater "fairness" of such a redistribution, and *there was no claim that such retroactive application provided any direct or apparent benefits to the general public*?

TABLE OF CONTENTS

Page

STATEMENT OF THE CASE 2

A. Nature of the Action 2

B. The McDonald's System and The Franchise Agreements 4

SUMMARY OF ARGUMENT 6

ARGUMENT 7

I. THE COURTS BELOW CORRECTLY FOUND THAT THE FRANCHISE AGREEMENT ACT CONFLICTS DIRECTLY WITH FUNDAMENTAL PRINCIPLES OF PRE-EXISTING McDONALD'S FRANCHISE CONTRACTS 7

A. The Act Changes the Nature of the Contract and the Scope of the Transaction 7

B. The Act Changes the Term of the Contract From a Fixed Term Without a Right to Renewal to a Perpetually Renewable Term 9

C. The Act Eliminates McDonald's Contractual Right to Select the Persons With Whom It Wishes to Have Franchise Relationships in the Exercise of Its Judgment 10

TABLE OF CONTENTS – Continued

Page

D. No Common Law Duties Obviate the Conflict Between the Act and the Contracts, Because Neither in Iowa nor Elsewhere Does the Common Law Provide Parties to Agreements Like Those Here with Rights Like Those Conferred by the Act 11

II. THE HOLDING THAT THE ACT'S ALTERATION OF THE PARTIES' RIGHTS UNCONSTITUTIONALLY IMPAIRS THE OBLIGATION OF PRE-EXISTING CONTRACTS ACCORDS WITH PRECEDENT 14

A. The Courts Below Properly Found a Severe Impairment 15

B. The Courts Below Properly Found That The Act Does Not Serve a Public Purpose By Addressing Any Broad Social Problem. It Is Special Interest Legislation Which Simply Redistributes Private Contractual Benefits and Burdens 23

CONCLUSION 27

TABLE OF AUTHORITIES

Cases: Page

Allied Structural Steel Co. v. Spannaus,
438 U.S. 234 (1978) 15, 16, 17, 22, 23, 24

Anderson's Vehicle Sales, Inc. v. OMC-Lincoln,
287 N.W.2d 247 (Mich. Ct. App. 1979) 19

Arnott v. American Oil Co., 609 F.2d 873
(8th Cir.1979) 13, 14

Birkenwald Distrib. Co. v. Heublein, Inc.,
55 Wash. App. 1, 776 P.2d 721 (1989) 19

Boatland, Inc. v. Brunswick Corp., 558 F.2d 818
(6th Cir. 1977) 16

*Cambee's Furniture, Inc. v. Doughboy
Recreational, Inc.*, 825 F.2d 167 (8th Cir. 1987) 12

Centronics Corp. v. Genicom Corp., 132 N.H. 133,
562 A.2d 187 (1989) 12

Chico's Pizza Franchises, Inc. v. Sisemore,
544 F. Supp. 248 (E.D. Wash. 1981) 19

Conoco, Inc. v. Inman Oil Co., Inc., 774 F.2d 895
(8th Cir. 1985) 12

Domed Stadium Hotel, Inc. v. Holiday Inns, Inc.,
732 F.2d 480 (5th Cir. 1984) 12

*Energy Reserves Group, Inc. v. Kansas Power
& Light Co.*, 459 U.S. 400 (1983) 18, 22, 23, 24, 25

TABLE OF AUTHORITIES – Continued

Page

Exxon Corp. v. Eagerton, 462 U.S. 176 (1983) 25

Fickling v. Burger King Corp., 843 F.2d 1386, [1987-89 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 9099 (4th Cir. 1988) 12

Fireside Chrysler-Plymouth Mazda, Inc. v. Chrysler Corp., 129 Ill. App. 3d 575, 472 N.E.2d 861 (1984) 19

Fornaris v. Ridge Tool Co., 423 F.2d 563 (1st Cir. 1970) 19

G-H Ins. Agency, Inc. v. Continental Ins. Co., 278 S.C. 241, 294 S.E.2d 336 (1982) 19

Garris v. Hanover Ins. Co., 630 F.2d 1001 (4th Cir.1980) 19

General Aviation, Inc. v. Cessna Aircraft Co., 915 F.2d 1038 (6th Cir. 1990) 14

General Offshore Corp. v. Farrelly, 743 F. Supp. 1177 (D.V.I. 1990) 19. 20, 22

Globe Liquor Co. v. Four Roses Distillers Co., 281 A.2d 19 (Del. 1971) 19

Heublein, Inc. v. Department of Alcoholic Bev. Control, 237 Va. 192, 376 S.E.2d 77 (1989) 19

In re Vylene Enters., Inc., 105 B.R. 42 (Bankr. C.D. Cal. 1989) 14

TABLE OF AUTHORITIES – Continued

Page

Jacobsen v. Anheuser-Busch, Inc., 392 N.W.2d 868 (Minn. 1986) 19

Keystone Bituminous Coal Ass'n v. DeBenedictis, 480 U.S. 470 (1987) 25, 26

Larco Distrib., Inc. v. Latrobe Brewing Co., 1990 WL 168702 (D. Kan. 1990) 19

Larese v. Creamland Dairies, Inc., 767 F.2d 716 (10th Cir. 1985) 13

Mankato Implement Inc. v. J.I. Case Co., [1990-1992 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 9947 (D. Minn. 1991) 19

Mariniello v. Shell Oil Co., 511 F.2d 853 (3d Cir. 1975) 14

Martino v. McDonald's Corp., 101 Wis. 2d 612, 304 N.W.2d 780 (1981) 19

McAleer Buick-Pontiac Co. v. General Motors Corp., 95 Ill. App. 3d 111, 419 N.E.2d 608 (1981) 21

McDonald's Corp. v. Markim, Inc., 209 Neb. 49, 306 N.W.2d 158 (1981) 21

Midwest Management Corp. v. Stephens, 291 N.W.2d 896 (Iowa 1980) 12

Morgan v. Kemper Ins. Co., 754 F.2d 145 (4th Cir. 1985) 19

TABLE OF AUTHORITIES – Continued

Page

N.A. Burkitt, Inc. v. J.I. Case Co., 597 F. Supp. 1086 (D. Me. 1984) 19, 20, 22

Northshore Cycles, Inc. v. Yamaha Motor Corp., 919 F.2d 1041 (5th Cir. 1990) 19, 20

Park Benziger & Co. v. Southern Wine & Spirits Inc., 391 So. 2d 681 (Fla. 1980) 19

Rochester v. Royal Appl. Mfg. Co., 569 F. Supp. 736 (W.D. Wis. 1983) 19

Scheck v. Burger King Corp., 798 F. Supp. 692 (S.D. Fla. 1992) 12

Schieffelin & Co. v. Department of Liquor Control, 194 Conn. 165, 479 A.2d 1191 (1984) 19, 22

Seegmiller v. Western Men, Inc., 20 Utah 2d 352, 437 P.2d 892 (1968) 13

Shell Oil Co. v. Marinello, 63 N.J. 402, 307 A.2d 598 (1973) 13

Shell v. Metropolitan Life Ins. Co., 181 W. Va. 16, 380 S.E.2d 183 (1989) 19

Smith Ins. Inc. v. Grievance Comm., 120 N.H. 856, 424 A.2d 816 (1980) 19

Superior Motors, Inc. v. Winnebago Indus., Inc., 359 F. Supp. 773 (D.S.C. 1973) 19

TABLE OF AUTHORITIES – Continued

Page

Troy Ltd. v. Renna, 727 F.2d 287 (3d Cir. 1984) 22, 26

United States Trust Co. v. New Jersey,
431 U.S. 1 (1977) 17, 18, 24, 25, 26

Veix v. Sixth Ward Bldg. & Loan Ass'n,
310 U.S. 32 (1939) 21, 22

Ward v. Chevron U.S.A. Inc., 123 Ariz. 208,
598 P.2d 1027 (1979) 19

Westfield Centre Serv., Inc. v. Cities Serv. Oil Co.,
86 N.J. 453, 432 A.2d 48 (1981) 16

William C. Cornitius, Inc. v. Wheeler, 276 Or. 747,
556 P.2d 666 (1976) 14

Willys Motors, Inc. v. Northwest Kaiser-Willys, Inc.,
142 F. Supp. 469 (D. Minn. 1956) 19

Wipperfurth v. U-Haul Co., 101 Wis. 2d 586,
304 N.W.2d 767 (1981) 19

Constitutions and Statutes

United States Const., Art. I, § 10 ..... *passim*

Indiana Deceptive Franchise Practice Act of 1987
§ 23-2-2.7-6 21

Iowa Code § 523H.2 3

Id. § 523H.5 11

TABLE OF AUTHORITIES – Continued

Page

Id. § 523H.6 ..... 3, 9

Id. § 523H.7 10

Id. § 523H.8 ..... 4, 10

Virginia Petroleum Products Franchise Act § 59.1-21.17 21

Virginia Retail Franchising Act § 13.1-574 21

Miscellaneous

Restatement (Second) of Contracts § 205 11

No. 94-618

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

STATE OF IOWA, TERRY E. BRANDSTAD, and,
IOWA FRANCHISEE ASSOCIATION,

Petitioners,

vs.

HOLIDAY INNS FRANCHISING INC.,
HOLIDAY INNS, INC., and
McDONALD'S CORPORATION,

Respondents.

Joint Petition for Writ of Certiorari
To The United States Court of Appeals
For The Eighth Circuit

BRIEF OF McDONALD'S CORPORATION IN OPPOSITION TO CERTIORARI

McDonald's Corporation[1] files this brief in opposition to the Petition for Certiorari to review the judgment of the United States Court of Appeals in this case.

The decision below is not in conflict with any decision of this Court or with the decisions of any other circuit. Rather, it reflects the decisional framework established by this Court and accords with a

---

[1] McDonald's has no affiliates requiring disclosure under Rule 29.1. Parties not listed in the caption are Steven L. Nelson and Tass Corporation, which is wholly owned by Mr. Nelson.

multitude of other decisions which have considered similar issues. It presents no novel or unsettled issue requiring resolution by this Court.

STATEMENT OF THE CASE

This case was decided on summary judgment. Neither here nor below have petitioners contended that there is any dispute as to the material facts, which the record shows to be as follows.

A. Nature of the Action

McDonald's owns, develops, franchises, and operates a restaurant "system" which brings together its concepts for developing and maintaining an economically sound McDonald's restaurant marketing system, principles and operating practices developed through experience, and proprietary rights in certain trade names, service marks and trademarks, including "McDonald's" and "McDonald's Hamburgers". (Depending on context, the term "McDonald's System" refers either to the total organization composed of McDonald's and its franchisees or to the concepts and methods of operation utilized by that organization.) McDonald's selects locations to be developed as restaurants, buys or leases real property, and invests substantial amounts of its own capital (often exceeding $1 million per new restaurant) in constructing and developing those restaurants. It then selects individuals to operate specific restaurants for defined terms (generally 20 years). (Eighth Circuit Joint Appendix ["JA"] 59-62.)

Steven L. Nelson is a party to six franchise agreements for McDonald's restaurants in or near Des Moines, Iowa, including one at 4812 S.W. 9th Street, Des Moines ("the 9th Street McDonald's") and one at 3000 S.E. 14th Street, Des Moines ("the 14th Street McDonald's").[2] Mr. Nelson, with the consent of McDonald's, has

---

[2] Nelson, with the consent of McDonald's, purchased the franchises from a prior franchisee, Arch Madden. Nelson personally agreed to perform all of the terms and conditions of the franchises, and agreed that "[a]ll terms and conditions of the Franchise shall remain in full force and effect." (JA 76-77, 83.) McDonald's leases the premises of the 9th Street McDonald's and is the fee owner of the premises of the 14th Street McDonald's. (JA 86-87.)

assigned all of the franchise agreements to Tass Enterprises, Inc. ("Tass"), a corporation wholly owned by him. (JA 57.) (Mr. Nelson and Tass will be referred to collectively as "Nelson.")

The 9th Street McDonald's franchised to Nelson is within a three-mile radius of a location at Fleur Drive and Wakonda View, Des Moines ("the Fleur Drive location"), where McDonald's has been planning to develop a new restaurant on premises it is acquiring. But for the purported applicability of the Act to the pre-existing agreements between McDonald's and Nelson, McDonald's would develop a restaurant at the Fleur Drive location. (JA 84-85.)

If McDonald's developed such a restaurant, it would determine, in its own business judgment, whether the proposed location would be operated through its own subsidiary or by a franchisee. In the latter case, McDonald's would offer the operation to one of several current franchisees or to a first-time franchisee, based on its judgment as to the long-term interests of the McDonald's System. (JA 85-86.)

Development of the Fleur Drive location is affected by the Iowa Franchise Act ("Act").[3] Section 6 of the Act denies McDonald's the right to open a restaurant at the Fleur Drive location unless it either offers a franchise for that location to Nelson or compensates Nelson based on the notion that some undefined volume of business to be conducted at the Fleur Drive location belongs to the 9th Street McDonald's. McDonald's asserts that the Act's requirement that it disregard its contract rights and act in this manner is invalid. (JA 86.)

The franchise agreement for the 14th Street McDonald's was issued for a twenty-year term commencing on the opening date of the restaurant, December 17, 1974. (JA 86.) *While Nelson has not been an unsatisfactory franchisee, McDonald's has a contract right to make a new term decision based on its own judgment and, pending further review of the constitutional status of the Act, does not wish to offer any new or rewritten franchises potentially subject to the Act.*

---

[3] The Act will be cited here solely by its own section numbers. (Section "x" of the Act is codified as Iowa Code § 523H.x.) The Act became law on April 23, 1992. By its terms (§ 2), the Act "applies to a new *or existing* franchise" (emphasis added).

But Section 8 of the Act purports to require McDonald's to continue Nelson as franchisee beyond the contract term, absent "good cause" not to do so.

McDonald's challenges the validity of the Act's provisions which attempt to confer on Nelson protection against McDonald's market development, the right to renewal of his franchises, and various other rights denied by its agreements with Nelson. Nelson insists on his rights under the Act. (JA 86, 89.) McDonald's brought this action against Nelson for a declaration of the parties' rights in light of the Act. The State of Iowa and the Iowa Franchisee Association, the petitioners here, intervened to defend the validity of the Act. Both courts below found that the provisions challenged by McDonald's unconstitutionally impair the franchise agreements with Nelson insofar as those provisions confer upon him rights inconsistent with the express terms of the agreements. *McDonald's Corp. v. Nelson*, 822 F. Supp. 597 (S.D. Iowa 1993), *aff'd sub nom. Holiday Inns Franchising, Inc. v. Brandstad*, 29 F.3d 383 (8th Cir. 1994).

B. The McDonald's System and The Franchise Agreements[4]

McDonald's has been committed to the franchise relationship as its fundamental business method for over thirty years. McDonald's has been able to pursue its commitment to franchising because it, and its franchisees, have been able to rely on the careful balance, shared economic investments and incentives, and mutual relationships established by the fundamental concepts and provisions of the franchise contract. (JA 57-58.) Application of these concepts and provisions — which are discussed in greater detail below — has made McDonald's and its franchisees one of the most (if not the most) successful franchising organizations in the United States. The acceptability of these concepts and provisions of a McDonald's franchise is confirmed by the strong demand for franchises on the terms which McDonald's has established. (JA 58-59.)

---

[4] Judging the severity of a contractual impairment requires that the terms altered be viewed in their commercial context. Because appellants completely disregard that context, which is not disputed, it must be developed at some length in this brief.

Three key franchise contract elements significantly contribute — individually and together — to the success of McDonald's and the success of its franchisees, by providing flexibility and incentives which enable the franchise network to be an effective, consumer-oriented and service-oriented competitor. These elements are:

a. The principles that a McDonald's franchise is limited to a right to conduct operations at a single and specific McDonald's restaurant location; that franchising decisions are made one-at-a-time; and that the process of new restaurant development is based on sound marketing and consumer service principles rather than on inflexible contract commitments.

b. The principle that, rather than being perpetual or subject to automatic renewal, the McDonald's franchise is limited to a specific period of time, generally twenty years.

c. The principle that McDonald's can select those with whom it will have a franchise relationship, and that franchises are granted to individual entrepreneurs (and their spouses, if desired) who live in the locality of their McDonald's restaurant and who actually own and will continue to own the entire equity interest in the business, without investors, minority "partners" and other "passive" parties. (JA 59.)

In the ongoing development of an economically-sound franchise network which will provide opportunities for the company and its franchisees, McDonald's evaluates and analyzes the overall marketplace for food service before any franchising decision is made. McDonald's identifies locations to be developed, without considering the identity of potential operators for those locations, and buys or leases those locations. (JA 60.)

McDonald's later decides how the location will be operated and, when an individual is selected to operate the restaurant, it offers a franchise contract to operate that restaurant. The franchise agreement sets an overall economic balance between McDonald's and its franchisees to provide McDonald's, its franchisees, and its future franchisees all with an opportunity to prosper — an opportunity proven by the success of both franchisees and the company and by the ability to continue to attract prospective franchisees. (JA 60.) Franchisees depend on having strong McDonald's operations, not only at the franchisees' own locations, but overall. (JA 60-61.) Part of what attracts franchisees to McDonald's is the fact that the terms of the franchise agreements provide both individual opportunity and the ability, utilizing McDonald's business judgment, to foster and protect the overall long-term interests of the McDonald's System. (JA 61.)

The allocation of rights, obligations and risks agreed to between McDonald's and its franchisees in the franchise agreements provides franchisees with incentives to maximize their operational performance. And it provides McDonald's with the flexibility needed to respond to market developments, demographic changes, consumer demand, competitive circumstances, and other factors in a rapidly-changing business environment. (JA 62.)

McDonald's gave its consent to Nelson's acquisitions of franchise rights (see note 2, *supra*) in reliance on the provisions of the franchise agreements, which were well known to all parties when Nelson and Madden negotiated the consideration paid by Nelson to acquire the McDonald's franchises. (JA 79-83.) Other franchisees have also relied on those terms and on their confidence in the judgment of McDonald's, rather than the legislature, to operate a successful franchise system. (JA 84.)

SUMMARY OF ARGUMENT

The courts below correctly held that the Contract Clause imposes more stringent limits than equal protection or substantive due process on state legislation that retroactively redistributes contractual benefits and burdens. Impairment occurs when a statute redistributes contractual benefits and burdens during the life of the contract, while requiring the disadvantaged party to continue performing the altered

contract. The impairment is severe if the terms altered were material to the original structuring and pricing of the bargain between the contracting parties. The courts below properly found a severe impairment here because the Act alters fundamental contractual terms which bore directly on the willingness of McDonald's to enter into the agreements and on the pricing and other elements of the bargain.

The courts below also correctly applied the principle that a severe impairment is prohibited unless retroactive application of the statute to pre-existing contracts is shown to have a "significant and legitimate public purpose" and to be reasonably related to that purpose. A purpose is legitimate if it pertains to protection of the interests of those not parties to the contract, *but not if it relates solely to redressing what the legislature considers an unfair distribution of benefits and burdens between the contracting parties, absent unexpected developments which produce a windfall to one of the parties.* It is undisputed that the sole purpose of the Act was to restructure supposedly unfair bargains between franchisors and franchisees, with no direct benefit to any third parties. That purpose cannot justify the resulting severe contractual impairment.

ARGUMENT

I. THE COURTS BELOW CORRECTLY FOUND THAT THE FRANCHISE AGREEMENT ACT CONFLICTS DIRECTLY WITH FUNDAMENTAL PRINCIPLES OF PRE-EXISTING MCDONALD'S FRANCHISE CONTRACTS.

A. The Act Changes the Nature of the Contract and the Scope of the Transaction.

McDonald's franchise agreements accord a right to operate one restaurant at a specific location. Nelson's franchise agreements, in accordance with McDonald's customary practices (JA 63), provide that: "*this License establishes a Restaurant at the location specified in sub-paragraph 2(a)(i) only and that no 'exclusive,' 'protected' or other territorial rights in the contiguous market area of such Restaurant is hereby granted or inferred.*" Before acquiring the franchises, Nelson was given Franchise Offering Circulars which stated that none

of the agreements "contain *any* exclusive grant, exclusive area, exclusive territorial rights, protected territory, nor any right to exclude, control or impose conditions on the location or development of future McDonald's restaurants at any time." (JA 85, 78 (emphasis added).)

The economic terms and performance provisions of the franchise agreements have been based on the absence of any territorial rights. There are no commitments to grant additional franchises. Accordingly, McDonald's franchisees' focus on building the opportunities presented by the single franchise restaurant is at the center of the ongoing McDonald's restaurant development program. They are not encouraged to focus on the prospects of developing more restaurants within some predetermined "territory," or on any guarantee that sales growth which may occur within such a "territory" will "belong" to the franchised operation which was there first. (JA 63.) The franchisee does not pay for such added rights. These limitations have provided McDonald's with the flexibility needed in a dynamic market environment to develop new restaurant locations in the most efficient way and to select the most appropriate operator for each location. (JA 63-64.)

McDonald's development of restaurants in an area takes place over an extended period. Sales patterns naturally shift. As an area evolves, additional McDonald's restaurants are needed to accommodate changes in customer patterns and respond to competition. (JA 66-67.) Such additions and realignments of sales patterns are anticipated by both McDonald's and its franchisees. McDonald's is thus contractually enabled to locate restaurants based on looking at how the *network* of McDonald's restaurants will function. The fact that decisions are made from a System-wide perspective, is a key element of McDonald's franchising, for both McDonald's and its franchisees. (JA 67.)

After McDonald's has decided to develop a new location, an *independent* decision is made whether that location should be franchised to an independent operator. If it is franchised, either a current franchisee or a prospective franchisee may be considered as the most desirable operator. Neither proximity of an existing franchisee to a new McDonald's restaurant site nor bare compliance with current franchise agreements warrants a new franchise offer. (JA 69-70.)

Due to the success of the McDonald's System, and their own success as part of it, most McDonald's franchisees want more McDonald's franchises. *McDonald's has found that the absence of any territorial rights for franchisees has served as a significant incentive for franchisees to do more than minimally comply with the franchise agreement.* (JA 70-71.)

Section 6 of the Act purports to limit McDonald's development of new restaurant locations and overrides the provisions of Nelson's franchise agreements which deny any territorial rights or protection against future restaurant development. The purported right conferred by Section 6 directly impacts whether McDonald's will develop a restaurant at the Fleur Drive location and, if it does so, its absence of obligation to Nelson regarding that location. The courts below thus concluded correctly that this provision of the Act works a fundamental change in the existing McDonald's contracts.

B. The Act Changes the Term of the Contract From a Fixed Term Without a Right to Renewal to a Perpetually Renewable Term.

The McDonald's franchise agreement limits the franchise to a specific period, generally twenty years; franchises are not renewed or extended on expiration unless the parties make a new agreement. As a result, a franchisee knows that an offer of a new franchise (a "rewrite") at the same restaurant location will not be obtained merely by avoiding material breaches of the franchise agreement. McDonald's is not compelled to continue its franchise relationship, beyond the term, with a franchisee whose performance, involvement or attitude is less desirable than that of other possible operators. The economic terms on which the franchise is offered reflect that fact. (JA 71.)

Each of Nelson's franchise agreements has a single twenty–year term. In each, the franchisee acknowledges the limited term of the franchise and that there is "no promise or representation as to the renewal of this [franchise] or the grant of a new [franchise]." Before acquiring the franchises from Madden, Nelson was given Franchise Offering Circulars which stated that "[t]he franchise does not grant the franchisee a right to renew or extend. Issuance of a new franchise after franchise expiration lies solely in the discretion of the Franchisor."

(JA 77, 78, 86-88.) *McDonald's has found that the contractual allocation of rights with respect to the franchise term has served as a significant incentive to maximize franchisee performance and dedication.* (JA 73-74, 59-60.)

Section 8 of the Act forbids a franchisor to refuse to renew a franchise unless upon six months' notice before expiration and for "good cause." "Good cause" has two elements: it must be "based upon a legitimate business reason," which "includes the failure of the franchisee to comply with any material lawful requirement of the franchise agreement," and it must not be "arbitrary or capricious when compared to the actions of the franchisor in other similar circumstances." Act §§ 8(2)(a) & 7(1). Section 8 thus contravenes the agreement that Nelson's franchise is granted only for a limited term, with no right to continue longer unless McDonald's freely chooses to grant further rights. The courts below concluded correctly that this provision of the Act works a fundamental change in the existing McDonald's contracts.

C. The Act Eliminates McDonald's Contractual Right to Select the Persons With Whom It Wishes to Have Franchise Relationships in the Exercise of Its Judgment.

McDonald's grants franchises only to those individuals who live near their McDonald's restaurants, who actually own and will continue to own the entire equity interest in the restaurants and their profits, and who will work full-time at their McDonald's restaurant business. McDonald's does not grant franchises to (or permit interests in franchises to be owned by) absentee investors or business entities that are separate from the interests of the individual franchisee(s). (JA 65-66.)

McDonald's recruits and trains individuals with motivation and entrepreneurial talent to become active, on-premises franchisees. (JA 66.) McDonald's believes that the McDonald's franchise cannot be subordinated to a position where the franchisee (or someone financially interested in a franchise) may treat the franchise as just one of many business activities or investments, diluting his or her commitment to make the McDonald's restaurant a successful part of the entire System of restaurants and franchisees and diluting the reward which the franchisee earns by his or her efforts. (JA 66.)

Nelson's franchise agreements (and the Franchise Offering Circular given to Nelson before he acquired Madden's franchises) provide that the franchisee specifically agrees to personally devote full-time efforts to the restaurants. (JA 78, 80-81.) The franchisee also warrants that he is the only person with any equity or other interest in the franchises; and that he will not make nor permit the creation of new or additional equity, partnership, capital or other interests in the franchises nor make or permit any direct or indirect subsequent assignment or transfer of any issued and outstanding equity interests, without the prior written consent of McDonald's. (JA 80-81, 89, 78.)

Sections 5(4) and 5(13) of the Act provide franchisees a variety of rights to transfer their interests in their franchises, including (1) the right to offer minority ownership interests to public shareholders or others not involved in the business without franchisor approval, (2) the right to transfer minority ownership interests to employee stock ownership plans without notice to or approval by the franchisor, and (3) the right to grant security interests in the franchise to lenders without notice to the franchisor despite contractual prohibitions. The courts below concluded correctly that these provisions of the Act work a fundamental change in the existing McDonald's contracts.

D. No Common Law Duties Obviate the Conflict Between the Act and the Contracts, Because Neither in Iowa nor Elsewhere Does the Common Law Provide Parties to Agreements Like Those Here with Rights Like Those Conferred by the Act.

Petitioners suggest that the Act does not alter contract terms because similar restrictions are already inherent in Iowa common law. (Pet. 12, 19-20.) As McDonald's showed the courts below, the overwhelming weight of authority leaves no doubt that the implied contractual duty of good faith contract performance referenced by petitioners provides no support for the contract-overriding duties created by the Act. Good faith contract performance is an obligation, implicit in all contracts, which is circumscribed by the express provisions of the contract and involves mutual duties which are predicated on the agreed purpose and consistent with the justified expectations of the parties. Restatement (Second) of Contracts § 205.

It "imposes upon each party the duty to do nothing destructive of the other party's right to enjoy the fruits of the contract and to do everything that the contract presupposes they will do to accomplish its purpose." *Conoco Inc. v. Inman Oil Co., Inc.*, 774 F.2d 895, 908 (8th Cir. 1985).

The implied duty of good faith performance is intended *only* to give effect to the intention of the parties as expressed in their contract.[5] It cannot override or contradict an express term of the contract, or require granting of benefits which the parties did not regard as part of the bargain.[6]

Express terms, which expressly negate expectations which might otherwise be inferred from the agreement, remain fully effective. Here the contractual documents (1) expressly negate "*any* right to exclude, control or impose conditions on the location or development of future McDonald's restaurants at any time"[7] (JA 85, 78 (emphasis

---

[5] *Midwest Management Corp. v. Stephens*, 291 N.W.2d 896, 913 (Iowa 1980), found a facially absolute power of cancellation qualified by an implied obligation of good faith because such a limitation was necessary to establish mutuality of obligation and so preserve the enforceability of the contract. No such implied limitations are necessary to establish mutual obligations in the franchise agreement here.

[6] *See, e.g., Cambee's Furniture, Inc. v. Doughboy Recreational, Inc.*, 825 F.2d 167, 174-75 (8th Cir. 1987) (South Dakota law) (implied covenant of good faith is an aid to contract interpretation, not a separate cause of action); *Domed Stadium Hotel, Inc. v. Holiday Inns, Inc.*, 732 F.2d 480, 485 (5th Cir. 1984) (Louisiana law) (duty of good faith did not override express right of franchisor to open new hotels anywhere other than franchised site); *Centronics Corp. v. Genicom Corp.*, 132 N.H. 133, 562 A.2d 187, 193-96 (1989) (Souter, J.) (no implied duty of buyer to consent to release amount undisputedly due to seller from contractual escrow, pending resolution of other disputes).

[7] *Scheck v. Burger King Corp.*, 798 F. Supp. 692, 695-99 (S.D. Fla. 1992), construed a franchise agreement containing language similar to that in Nelson's agreement. *Id.* at 695. It held that, absent an express grant of power to the franchisor to locate restaurants wherever it chose, the franchisor's right to do so was still constrained by a duty of good faith. But the same contract had received a contrary construction in *Fickling v. Burger King Corp.*, 843 F.2d 1386, [1987-89 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 9099 (4th Cir. 1988). *Scheck*'s construction appears to be incorrect. But *Scheck* is also distinguishable, because McDonald's contract rights here were explained by the Offering Circular language quoted in text and were well understood by the parties.

added); (2) expressly provide that "[t]he franchise does not grant the franchisee a right to renew or extend. Issuance of a new franchise after franchise expiration lies solely in the discretion of the Franchisor" (JA 77-78); and (3) specify that one of the basic tenets of the McDonald's System is "having a franchisee on the Restaurant premises who personally devotes full time and best efforts to the operation of the Restaurant and owns the entire equity interest in the Franchise and its profits" (JA 82). Thus, rights to territorial protection, renewal, and transfer to passive interests were unmistakably excluded from the interests protected by the duty of good faith.

There was no need for the courts below to discuss petitioners' argument on this point, as it was shown to be totally without merit. Most of the cases on good faith relied upon by appellants deal with franchises or dealerships of indefinite duration terminable on short notice, with no explicit statement of permissible grounds for termination. In such cases, courts commonly find an implied understanding that the franchisee or dealer will not be arbitrarily denied the opportunity to reap the benefits after it has made substantial commitments of time and money beneficial to the franchisor. *E.g., Seegmiller v. Western Men, Inc.*, 20 Utah 2d 352, 437 P.2d 892, 894 (1968).[8] Moreover, as *Seegmiller* itself states, the rationale of its rule depends on the *absence* of express contractual provisions, like those here, negating the existence of the expectations allegedly protected by the implied term. Finally, the right to unilaterally terminate a governing agreement when

---

[8] Other cases based on this type of analysis, and a similar absence of express preservation of the franchisor's freedom, include *Arnott v. American Oil Co.*, 609 F.2d 873, 881-84 (8th Cir. 1979), *cert. denied*, 446 U.S. 918 (1980) (termination without cause following repeated threats of nonrenewal, violative of prior express assurances of independence in operation and prior custom of routine renewal which had induced dealer to accept transfer to this location); *Larese v. Creamland Dairies, Inc.*, 767 F.2d 716 (10th Cir. 1985) (duty of good faith limits power to deny approval of assignment of franchise). In the context of a one-sided short-term service station lease, the New Jersey Supreme Court declared a public policy against franchise agreements which could be nonrenewed without cause. *Shell Oil Co. v. Marinello*, 63 N.J. 402, 307 A.2d 598, 602 (1973), *cert. denied*, 415 U.S. 920 (1974). No other court has agreed, and it is not clear that even New Jersey would apply that rule to the more balanced, long-term agreement here.

it has not expired is fundamentally different from the right not to offer a new contract relationship after expiration of an old one.[9]

Because the common law duty of good faith, in the context of the sort of agreements here, would not protect the sorts of interests shielded by the Act, the effect of the Act cannot be regarded as an insignificant change or a mere codification of restraints imposed by common law in the absence of the Act.

II. THE HOLDING THAT THE ACT'S ALTERATION OF THE PARTIES' RIGHTS UNCONSTITUTIONALLY IMPAIRS THE OBLIGATION OF PRE-EXISTING CONTRACTS ACCORDS WITH PRECEDENT.

Article I, § 10 of the United States Constitution, the Contract Clause, provides that "[n]o State shall . . . pass any . . . Law impairing the Obligation of Contracts."[10] It is well established that the Contract Clause coexists with an extremely broad range of state power:

---

[9] The duty of good faith is a duty to do nothing which will deprive the other party of the intended benefits of the agreement. It thus protects the promises *already* made in that agreement. *It does not require the making of new promises or the undertaking of new obligations,* unless there has been an express or implied promise to do so. *Cf. In re Vylene Enters., Inc.*, 105 B.R. 42 (Bankr. C.D. Cal. 1989), *vacated*, 122 B.R. 747 (C.D. Cal. 1990), *appeal dismissed*, 968 F.2d 887 (9th Cir. 1992); *Arnott v. American Oil Co.*, 609 F.2d 873, 881-84 (8th Cir. 1979), *cert. denied*, 446 U.S. 918 (1980) (analyzing termination without cause but relying in part on an implied undertaking created by contractual silence on renewal rights and prior custom of routine renewal which had induced dealer to accept transfer to this location). Thus, the duty of good faith, *standing alone,* does not limit or restrict a party's discretion whether to enter a new contract by imposing a duty to do so absent cause for nonrenewal. *E.g. General Aviation, Inc. v. Cessna Aircraft Co.*, 915 F.2d 1038, 1041-42 (6th Cir. 1990) (Michigan law) (distributorship); *William C. Cornitius, Inc. v. Wheeler*, 276 Or. 747, 556 P.2d 666, 670 (1976) (service station dealer).

[10] By its terms, the Contract Clause does not apply to *judicial* invalidations of prior contract rights in developing the common law. *Mariniello v. Shell Oil Co.*, 511 F.2d 853, 859-60 (3d Cir. 1975).

> "It is the settled law of this [C]ourt that the interdiction of statutes impairing the obligation of contracts does not prevent the State from exercising such powers as are vested in it for the promotion of the common weal, or are necessary for the general good of the public, though contracts previously entered into between individuals may thereby be affected. . . ." As Mr. Justice Holmes succinctly put the matter. . . . "One whose rights, such as they are, are subject to state restriction, cannot remove them from the power of the State by making a contract about them. The contract will carry with it the infirmity of the subject-matter."

Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 241-42 (1978) (citations omitted). But the statute here is not within the ambit of state power to modify pre-existing contracts.

As *Spannaus* holds, despite the remaining breadth of state power, the Contract Clause "is not a dead letter." *Id.* at 241. For it "to retain any meaning at all, . . . it must be understood to impose *some* limits upon the power of a State to abridge existing contractual relationships, even in the exercise of its otherwise legitimate police power." *Id.* at 242.

The courts below correctly applied the methodology laid down by this Court for assessing impairment of contract claims. Under that methodology, a statute which modifies pre-existing contractual rights is valid (a) if the impact on those rights is sufficiently minimal *or* (b) if the statute is justified by a sufficiently overriding legislative purpose. In the latter case, the contractual modification also must be both reasonable and appropriate to the public purpose which justifies the modification.

A. The Courts Below Properly Found a Severe Impairment.

The first step in the inquiry is to determine whether any impact on contractual rights is so minimal as to be beneath constitutional notice:

> The severity of the impairment measures the height of the hurdle the state legislation must clear. Minimal alteration of contractual obligations may end the inquiry at its first stage. Severe impairment, on the other hand, will push the inquiry to a careful examination of the nature and purpose of the state legislation.

Id. at 245.

The courts below found that the impairment here is not minimal, for it directly alters central elements of the contract. As the district court found, the Act "materially changes the rights to which the parties agreed and for which they gave consideration." 822 F. Supp. at 606, App. at 27. The Eighth Circuit generally approved the district court's analysis and, on this point, specifically concluded that "[w]e do not think it can be seriously contested that the retroactive feature of the [Act] substantially impaired the obligations previously owed to the plaintiffs in this case." 29 F.3d at 384, App. at 4.

Here, the legislature has attempted *to alter the terms of existing bargains* between McDonald's and its Iowa franchisees *and to force McDonald's to continue performing under the altered terms*, regardless of the impact on the original bargain. *It is this redistribution of benefits and burdens between the contracting parties which is the essence of impairment.* In contrast, where the state merely regulates prospectively and leaves parties free to contract (or not) in light of the regulation, no redistribution occurs and no Contract Clause issue arises.[11]

The Contract Clause protects reliance upon agreements to structure private affairs. As this Court explained in *Spannaus*:

---

[11] For example, *Boatland, Inc. v. Brunswick Corp.*, 558 F.2d 818 (6th Cir. 1977), and *Westfield Centre Serv., Inc. v. Cities Serv. Oil Co.*, 86 N.J. 453, 432 A.2d 48 (1981), *aff'g in pertinent part*, 158 N.J. Super. 455, 386 A.2d 448 (Ch. Div. 1978), both involved contracts made or renewed *after* enactment of the challenged statutes, so no impairment issue was (or could have been) presented.

> The severity of an impairment of contractual obligations can be measured by the factors that reflect the high value the Framers placed on the protection of private contracts. Contracts enable individuals to order their personal and business affairs according to their particular needs and interests. Once arranged, those rights and obligations are binding under the law, and the parties are entitled to rely on them.

438 U.S. at 245.

The key to determining the severity of an impairment is the extent to which the parties relied, in fixing the terms of their bargain, on the benefits or burdens which the impairing statute would eliminate. For example, in *Spannaus*, this Court found a severe impairment where a state attempted to confer on employees with ten years' service, who were terminated in plant closings, vesting rights in their pensions, even though their employers' pension plans denied such vesting.[19] Moreover, the Court did not require (as the dissenters would have, 438 U.S. at 253-54) that the company have made some specific reduction of its contributions to reflect the possibility that employees might be prevented from completing the service necessary for vesting because the office in which they worked might be closed. Thus, *the reliance which was important was that which occurred in defining the terms initially, not that shown in subsequent performance*. In light of this reliance, the subsequent impairment was "severe." *Id.* at 246.[12]

---

12 *United States Trust Co. v. New Jersey*, 431 U.S. 1 (1977), also shows that the focus in determining the severity of an impairment is on the importance of the relevant contractual term in reaching the original bargain, not on its value at the time of impairment. There, the Port Authority operated toll bridges and tunnels and a subsidized commuter railroad system and had issued revenue bonds. Investors were wary of additional money-losing rail operations, so the two states enacted a statutory covenant that no bonds were to be issued for railroad purposes unless total rail deficits were reduced below a given level. Later, the states substantially increased bridge and tunnel tolls, with a view to using the increased revenues for railroad purposes, and repealed the covenant against such use. The repeal was found to unconstitutionally impair the bond contracts.

footnote continued on page 18

If the terms to be altered *were* important to the structuring of the original bargain, and if the parties are forced to proceed on a basis they never would have agreed to in the first instance, there is a severe injury to that reliance interest (even if the economic impact at the time the alteration is imposed may seem relatively modest).[13] *See United States Trust Co. v. New Jersey*, 431 U.S. 1 (1977).

On the facts here, it is beyond question that the contractual terms altered by the Act (absence of territorial rights, limited franchise term, and the requirement that the franchise be owned entirely by an individual entrepreneur who would devote full time to the franchise) were fundamental to the bargain between Nelson and McDonald's when that bargain was made. The significance of those terms to both McDonald's and its franchisees is undisputed in the record and they are clearly, prominently, and emphatically stated in the agreement and in the accompanying materials provided to Nelson in connection with his purchase of the franchises.

---

footnote continued from page 17

The dissent argued that the repeal should have been sustained because the state courts had found the repeal had had only a minor impact on the value of the bonds. *Id.* at 41-44. But the Court found that, absent an attempt to substitute other rights for those taken away, the appropriate focus was instead on the *originally* intended significance of the rights impaired: "As a security provision, the covenant was not superfluous; it limited the Port Authority's deficits and thus protected the general reserve fund from depletion. Nor was the covenant merely modified or replaced by an arguably comparable security provision. Its outright repeal totally eliminated an important security provision and thus impaired the obligation of the States' contract." *Id.* at 19.

[13] By the same token, even if the impact at the time of impairment is relatively great, the impairment is still "minimal" if the magnitude of the impairment stems solely from developments never anticipated at the time of contracting, so that the parties would not *then* have attached great importance to the term later altered by statute. For example, the price adjustment terms in *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400 (1983), were very significant in the environment of deregulation which existed at the time of statutory modification. But no one had anticipated that sort of environment at the time of contracting, so the enormous benefit to the seller was a windfall, rather than an element of the value relied upon in structuring the contractual balance. *Id.* at 411-16.

Almost every case to consider a challenge to statutory changes to similar contractual terms has found a "severe" impairment.[14] *Petitioners entirely ignore this body of law, beyond citing the few outdated or distinguishable cases that upheld such statutes.*

Petitioners rely heavily on *General Offshore Corp. v. Farrelly*, 743 F. Supp. 1177 (D.V.I. 1990). There, a Virgin Islands statute

---

[14] *See, e.g., Northshore Cycles, Inc. v. Yamaha Motor Corp.*, 919 F.2d 1041, 1043 (5th Cir. 1990); *Morgan v. Kemper Ins. Co.*, 754 F.2d 145, 147-48 (4th Cir. 1985); *Garris v. Hanover Ins. Co.*, 630 F.2d 1001, 1005-07 (4th Cir. 1980); *Fornaris v. Ridge Tool Co.*, 423 F.2d 563 (1st Cir.), *rev'd on other grounds*, 400 U.S. 41 (1970) (resolution of constitutional question should have been deferred to see if Puerto Rico court might construe statute in a way avoiding that question); *Mankato Implement Inc. v. J.I. Case Co.*, [1990-1992 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 9947 (D. Minn. 1991); *Larco Distrib., Inc. v. Latrobe Brewing Co.*, 1990 WL 168702 (D. Kan. 1990); *Rochester v. Royal Appl. Mfg. Co.*, 569 F. Supp. 736 (W.D. Wis. 1983); *Chico's Pizza Franchises, Inc. v. Sisemore*, 544 F. Supp. 248, 249-50 (E.D. Wash. 1981), *aff'd*, 685 F.2d 440 (9th Cir. 1982); *Superior Motors, Inc. v. Winnebago Indus., Inc.*, 359 F. Supp. 773, 779 (D.S.C. 1973); *Shell v. Metropolitan Life Ins. Co.*, 181 W. Va. 16, 380 S.E.2d 183, 188-91 (1989); *Heublein, Inc. v. Department of Alcoholic Bev. Control*, 237 Va. 192, 376 S.E.2d 77, 79 (1989); *Birkenwald Distrib. Co. v. Heublein, Inc.*, 55 Wash. App. 1, 776 P.2d 721, 724-25 (1989); *Jacobsen v. Anheuser-Busch, Inc.*, 392 N.W.2d 868, 872-74 (Minn. 1986), *cert. denied*, 479 U.S. 1060 (1987); *Fireside Chrysler-Plymouth Mazda, Inc. v. Chrysler Corp.*, 129 Ill. App. 3d 575, 472 N.E.2d 861, 866 (1984); *G-H Ins. Agency, Inc. v. Continental Ins. Co.*, 278 S.C. 241, 294 S.E.2d 336 (1982); *Martino v. McDonald's Corp.*, 101 Wis. 2d 612, 304 N.W.2d 780 (1981); *Wipperfurth v. U-Haul Co.*, 101 Wis. 2d 586, 304 N.W.2d 767, 773 (1981); *Park Benziger & Co. v. Southern Wine & Spirits, Inc.*, 391 So. 2d 681 (Fla. 1980); *Smith Ins. Inc. v. Grievance Comm.*, 120 N.H. 856, 424 A.2d 816, 820 (1980); *Ward v. Chevron U.S.A. Inc.*, 123 Ariz. 208, 598 P.2d 1027 (1979); *Globe Liquor Co. v. Four Roses Distillers Co.*, 281 A.2d 19 (Del.), *cert. denied*, 404 U.S. 873 (1971).

Schieffelin & Co. v. Department of Liquor Control, 194 Conn. 165, 479 A.2d 1191 (1984), assumed "severe impairment" but did not decide that issue, because it found that the special regulatory needs of the liquor industry justified the statute. *Willys Motors, Inc. v. Northwest Kaiser-Willys, Inc.*, 142 F. Supp. 469 (D. Minn. 1956), and *Anderson's Vehicle Sales, Inc. v. OMC-Lincoln*, 287 N.W.2d 247 (Mich. Ct. App. 1979), upheld the statutes at issue on the basis of an adequate public purpose, without addressing whether the impairment was "severe." The sole contrary case, *N.A. Burkitt, Inc. v. J.I. Case Co.*, 597 F. Supp. 1086, 1091-92 (D. Me. 1984), relied on a history of pervasive regulation with no counterpart here. These were the only such cases to sustain the challenged statutes.

forbade discharge of any employee except for specified causes, though the court found that those included "almost every conceivable reason for which an employer might reasonably wish to discharge an employee." *Id.* at 1198. Some months after the statute was enacted, General Offshore sought to fire an employee who was hired before the statute was enacted. *Id.* at 1181. When the employee filed an administrative complaint alleging wrongful discharge, General Offshore sought to enjoin administrative proceedings on the ground, *inter alia*, that they impaired the implied contract of employment at will. The court held that the statute was not facially invalid.

General Offshore did not involve an impairment of the sort at issue here for at least two related reasons. First, the essence of the employer's contention was that the employment was at will. Thus, a new contract could be considered made every day. *See, e.g., Northshore Cycles, Inc. v. Yamaha Motor Corp.*, 919 F.2d 1041, 1043 (5th Cir. 1990). When General Offshore did not fire an employee immediately after the statute took effect, a new contract, fully consistent with the statute, was made.[15] Second, because the employment was at will, all of its terms other than job security (wages, hours, benefits) were likewise subject to alteration. Thus, employers were free to adjust those terms in whatever ways were necessary to restore the contractual balance in light of the change in job security. Here, in contrast, McDonald's is bound by long-term contracts with Nelson which it must continue to observe despite statutory modification of key terms.

Petitioners also attempt to dispute existence of a severe impairment by arguing that McDonald's *ought not to have had any firm contractual expectations* because it should have anticipated the "possibility" not only of future regulation but of retroactive regulation like that now imposed. (Pet. 19-21.) Given the pervasive nature of modern economic regulation, petitioners appear to assert that no one's contract rights are safe from redistribution while the legislature sits. The Contract Clause says otherwise.

---

[15] Similar reasoning applies to *N.A. Burkitt, Inc. v. J.I. Case Co.*, 597 F. Supp. 1086 (D. Me. 1984). Prior to the challenged 1981 statute, the dealership there was terminable on 60 days' notice. *Id.* at 1087. No termination was attempted until 1983, long after a new contract, governed by the new statute, had been formed.

The required anticipation, petitioners urge, should have resulted from Iowa's regulation of dealership relationships in selected other industries (motor vehicles, agricultural equipment, and motor fuel) and from regulation by other states of franchise relationships, in various industries (other than restaurants) or generally. They cannot cite any prior regulation by Iowa of restaurant marketing systems.

None of the regulatory schemes relied upon by petitioners below precluded the formation by McDonald's of expectations that it could rely upon the structuring of relationships created by its franchise agreements. Where franchise or dealership regulations of the sort involved here have been imposed, the legislation has typically provided that it applies only to newly formed relationships or has been so interpreted.[16] Where the legislation has not been so limited, its retroactive application to existing relationships has usually been held unconstitutional. (See cases collected at note 14, *supra*.) Thus, McDonald's had no reason to anticipate that such legislation, if enacted, would be applied to alter existing contracts, and it had every right to rely on the provisions of those contracts.[17]

The origin of this entire line of analysis is *Veix v. Sixth Ward Building & Loan Association*, 310 U.S. 32 (1939), which held when a party "purchased into an enterprise already regulated in the particular

---

16 *See, e.g.*, Virginia Retail Franchising Act § 13.1-574 ("The provisions of this chapter shall apply to grants and offers to grant franchises on and after July 1, 1972"); Virginia Petroleum Products Franchise Act § 59.1-21.17 ("The provisions of this chapter shall be applicable to franchise agreements entered into on or after July 1, 1973"); Indiana Deceptive Franchise Practice Act of 1987 § 23-2-2.7-6 ("The provisions of this chapter apply only to agreements entered into or renewed, or act or practice occurring after July 1, 1976"); *McAleer Buick-Pontiac Co. v. General Motors Corp.*, 95 Ill. App. 3d 111, 419 N.E.2d 608 (1981) (retroactive application of "good cause" renewal provision would impair the obligation of contract); *McDonald's Corp. v. Markim, Inc.*, 209 Neb. 49, 306 N.W.2d 158 (1981) (declining to apply Nebraska Franchise Act retroactively).

17 McDonald's also did not contract in the context of a regulated environment. The regulations now cited applied to other lines of business and/or in other states. Nothing in the case law forces a business enterprise which contracts in an unregulated environment to look to other industries or other states to ascertain whether it may form secure contractual expectations.

to which he now objects, he purchased subject to further legislation upon the same topic."[18] *Id.* at 38. *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 413-16 (1983), extended this notion to a business already *pervasively* regulated *by the very state which now proposes to adjust the contractual terms*, albeit not "in the particular" to which the plaintiff now objects.

In any event, *no* decision of this Court has *ever* upheld legislation which impairs contractual rights on the basis that allegedly similar regulations had previously been imposed by other states or on other businesses. This Court has never even *suggested* that legislation could be upheld on that basis. Indeed, no party to this action has ever cited a single case, *in any court*, which has ever sustained a statute on that ground.[19]

---

[18] The principal cases relied upon here are ones where the state accused of impairment had already regulated the contract "in the particular" which was the subject of the later statute or had expressly reserved the right to do so. *Troy Ltd. v. Renna*, 727 F.2d 287, 298 (3d Cir. 1984) (new statute expanded and extended for some tenants, protected rights to remain in their apartments previously established under an earlier, unchallenged statute); *General Offshore Corp. v. Farrelly*, 743 F. Supp. 1177 (D.V.I. 1990) (state had previously prohibited employee discharges contrary to public policy, so requirement of good cause for discharge was minimal impairment); *N.A. Burkitt, Inc. v. J.I. Case Co.*, 597 F. Supp. 1086, 1092 (D. Me. 1984) (change from requiring "due cause" for termination to requiring "good cause" and mandating a six-month "cure" period only minimal impairment); *Schieffelin & Co. v. Department of Liquor Control*, 194 Conn. 165, 479 A.2d 1191 (1984) (state already regulated termination of wine dealerships, though prior regulation did not restrict termination until dealership had been in existence for 24 months, as opposed to six months under the new statute).

[19] Petitioners' approach would also have led to an opposite result in *Spannaus*, as pension plans had long been regulated extensively by the tax laws and a longstanding political effort to regulate vesting — the subject of the invalid statute — was just reaching fruition in the 1974 enactment of ERISA when the Minnesota statute was passed. Moreover, petitioners' test would have denied the central result intended to be accomplished by the Contract Clause: prohibition of retroactive debtor relief legislation. Such legislation had long been part of the political dialog and had actually been adopted in a number of jurisdictions. Thus, if petitioners are correct, creditors should have continued to expect such legislation even after adoption of the Contract Clause.

B. The Courts Below Properly Found That The Act Does Not Serve a Public Purpose By Addressing Any Broad Social Problem. It Is Special Interest Legislation Which Simply Redistributes Private Contractual Benefits and Burdens.

If a more than minimal impairment is found:

> the State, in justification, must have a significant and legitimate public purpose behind the regulation, such as the remedying of a broad and general social or economic problem. . . . The requirement of a legitimate public purpose guarantees that the State is exercising its police power, rather than providing a benefit to special interests.

Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 U.S. 400, 411-12 (1983) (citations omitted).

At this step, the statute must fail unless there is a *showing*, in the record or through judicially noticeable facts, that the

> disruption of contractual expectations was necessary to meet an important general social problem. The presumption favoring "legislative judgment as to the necessity and reasonableness of a particular measure," simply cannot stand in [the face of a severe impairment].

Spannaus, 438 U.S. at 247 (citation omitted).

Here, the defenders of the statute cannot make the required showing because, as shown below, the statute addresses *no* "important general social problem." Rather, it serves only to benefit a special interest — franchisees whose contractual rights and obligations are

altered. Thus, the statute cannot stand.[20] The district court, whose analysis the Eighth Circuit generally approved, specifically found an absence of any public purpose. 822 F. Supp. at 608-09.

Because the Franchise Agreement Act severely impairs the pre-existing contracts between McDonald's and Nelson, it cannot stand unless the impairments are justified by a legitimate public purpose and are both reasonable in light of that purpose and granted on conditions appropriate to that purpose. This Court has emphasized that

> laws intended to regulate existing contractual relationships must serve a legitimate public purpose. A State could not "adopt as its policy the repudiation of debts or the destruction of contracts or the denial of means to enforce them."

United States Trust, 431 U.S. at 22 (citation omitted).

A "legitimate public purpose" which can justify contract impairment requires more than an objective which could support purely prospective legislation. Otherwise the Contract Clause would impose no independent limit at all.[21] *Spannaus*, 438 U.S. at 242. Thus,

---

[20] If there were a legitimate public purpose, analysis would turn to a third issue: "whether the adjustment of 'the rights and responsibilities of contracting parties [is based] upon reasonable conditions and [is] of a character appropriate to the public purpose justifying [the legislation's] adoption.'" *Energy Reserves*, 459 U.S. at 412-13 (citation omitted).

If the state is not a self-interested contracting party, *at this last stage of the analysis only*, "courts properly defer to legislative judgment as to the necessity and reasonableness of a particular measure." 459 U.S. at 413 (citation omitted). The courts below did not need to reach this step of the analysis because there was no public purpose shown.

[21] Once a legitimate purpose has been identified, a court applying either the Contract Clause, the Equal Protection Clause, or the substantive aspects of the Due Process Clause gives similar deference to legislative judgments about the necessity of the challenged legislation. See note 20, *supra*. Thus, the *only* possible difference concerns the range of permissible purposes.

> the State, in justification, must have a significant and legitimate public purpose behind the regulation, such as the remedying of a broad and general social or economic problem. . . . The requirement of a legitimate public purpose guarantees that the State is exercising its police power, rather than providing a benefit to special interests.

Energy Reserves, 459 U.S. at 411-12 (citations omitted).

Determination of what constitutes a "legitimate public purpose" sufficient to impair pre-existing private contracts must be made in light of the purpose of the Contract Clause, "to encourage trade and credit by promoting confidence in the stability of contractual obligations." *United States Trust*, 431 U.S. at 15. That purpose would be defeated if substantial contract impairments were lightly permitted.

In fact, such impairments have been sustained only when the state has shown a weighty purpose *going beyond readjustment of the rights of the contracting parties*, that is, a public purpose. *E.g.*, *Keystone Bituminous Coal Ass'n v. DeBenedictis*, 480 U.S. 470 (1987) (protection of public against environmental hazards of mine subsidence which would result if mining company exercised contractual right, acquired from surface owner, to remove subjacent support); *Exxon Corp. v. Eagerton*, 462 U.S. 176 (1983) (protection of ultimate consumers from price increases which would result if natural gas producers exercised contractual right to pass on severance tax increase to wholesalers); *Energy Reserves*, 459 U.S. 400, 416-17 (protection of utility customers from price increase which would result if gas producer were permitted to exercise contractual right to increase price to utility when federal government deregulated gas prices).

As the district court concluded,

> the articulated overall purpose of the Act is specifically to adjust the balance of power between contracting parties. Although defendants and intervenors urge that franchising is a growing practice and a growing part of the economy in Iowa and throughout the nation, that fact by

> itself does not supply a broad societal interest justifying the substantial impairment of *existing* contracts.

822 F. Supp. at 608-09, App. at 33.

The precise function of the Contract Clause is to preclude impairment for the very purpose relied upon here: redistributing benefits and burdens between the contracting parties ***because the legislature believes that result fairer or more just, as between those parties.***[22] *In contrast, as shown by the cases discussed at 25, supra, redistributive impacts on contracting parties are allowed if those impacts are only incidental to regulations whose primary purpose is protection of those who are not parties to the contracts impaired.*

Petitioners offer an alternate test: legislation which impairs contracts, they claim, must benefit some minimum number of people. (Pet. 12-13.) They derive this test by selectively pointing to cases where invalid legislation ostensibly benefited only a small group or valid legislation benefited a large group. But this proposal is not based on the language or purposes of the Contract Clause or supported by analysis or precedent. Indeed, the test proposed by appellants would prevent the Contract Clause from accomplishing its original purpose: prohibiting debtor-relief legislation. *See Keystone Bituminous Coal Ass'n v. DeBenedictis*, 480 U.S. 470, 503 (1987). Debtors are more numerous than franchisees. If sheer numbers were enough to permit impairment, debtor relief legislation would not be limited by the Contract Clause, independently of due process and equal protection. Moreover, the contract impairment in *United States Trust* was intended to benefit New York commuters, another very numerous class, but was nonetheless struck down.

In short, petitioners' argument in no way establishes that the courts below erred in concluding that the challenged provisions of the Act to existing contracts cannot be justified by any legitimate *public* purpose, as opposed to the purpose of protecting the special interests

---

[22] The statute upheld in *Troy Ltd. v. Renna*, 727 F.2d 287 (3d Cir. 1984), sought to protect not only the elderly tenants who were its direct beneficiaries but also the communities which would otherwise have been deprived of their presence. *Id.* at 290 n.2. It is, thus, distinguishable.

of franchisees *who are parties to the contracts which are to be impaired.* Absent any legitimate purpose for retroactive application, there is no occasion to inquire into the reasonableness or the means used to promote that nonexistent purpose.

CONCLUSION

This case presents no novel or unsettled issue, there is no significant disparity with other relevant decisions, and the courts below correctly applied the principles laid down by this Court. Accordingly, the petition for certiorari should be denied.

Respectfully submitted,

Alan H. Silberman
Sonnenschein Nath & Rosenthal
8000 Sears Tower
233 S. Wacker Drive
Chicago, IL 60606-6404
(312) 876-8000
Counsel of Record for
McDonald's Corporation

Of Counsel
Robert T. Joseph
William T. Barker
Jill A. Thompson
Sonnenschein Nath & Rosenthal
8000 Sears Tower
233 S. Wacker Drive
Chicago, IL 60606-6404

Shelby Yastrow
George T. Rummel
McDonald's Corporation
One McDonald's Plaza
Oak Brook, IL 60521

Kim J. Walker
Faegre & Benson
400 Locust Street, #400
Des Moines, Iowa 50309

No. 94-618

(3)

Supreme Court, U.S.
FILED
NOV 7 1994

In The

Supreme Court of the United States

October Term, 1994

STATE OF IOWA, TERRY E. BRANSTAD AND IOWA FRANCHISEE ASSOCIATION,

Petitioners,

vs.

HOLIDAY INNS FRANCHISING, INC., HOLIDAY INNS, INC. and McDONALD'S CORPORATION,

Respondents.

On Joint Petition for Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF IN OPPOSITION OF RESPONDENTS HOLIDAY INNS FRANCHISING, INC. AND HOLIDAY INNS, INC.

EDWARD W. REMSBURG
AHLERS, COONEY, DORWEILER, HAYNIE, SMITH & ALLBEE, P.C.
Suite 600
100 Court Avenue
Des Moines, Iowa 50309-2231
(515) 243-7611

JOHN G. PARKER
Counsel of Record
RONALD T. COLEMAN, JR.
JANET L. KISHBAUGH
PAUL, HASTINGS, JANOFSKY & WALKER
4200 Georgia-Pacific Center
133 Peachtree Street, N.E.
Atlanta, Georgia 30303-1840
(404) 588-9900

Attorneys for Respondents Holiday Inns Franchising, Inc. and Holiday Inns, Inc.

5899
Lutz Appellate Services, Inc.
(800) 3 APPEAL • (800) 5 APPEAL • (800) BRIEF 21

BEST AVAILABLE COPY

QUESTIONS PRESENTED

1. Did the Eighth Circuit and the District Court follow the well-established Contracts Clause analysis in holding the public purpose of the Iowa Franchise Act, which is to equalize bargaining power and redistribute rights between private contracting parties, insufficient to allow it to be applied retroactively to restructure Holiday Inns' rights under its pre-existing License Agreements?

2. Did the Eighth Circuit follow the Contracts Clause analysis prescribed by existing Supreme Court precedent in affirming the District Court's holding that the Iowa Franchise Act substantially impairs the contractual rights allocated in Holiday Inns' pre-existing License Agreements?

3. Did the Eighth Circuit follow established Contracts Clause analysis in concluding that the Iowa Franchise Act regulated an area of business not sufficiently regulated previously so as to allow Iowa to restructure the rights and expectations of the parties under Holiday Inns' pre-existing License Agreements?

PARTIES TO PROCEEDINGS

Petitioners are the State of Iowa; Terry E. Branstad, Governor of the State of Iowa; and the Iowa Franchisee Association.

Respondents are Holiday Inns Franchising, Inc., Holiday Inns, Inc. and McDonald's Corporation.

TABLE OF CONTENTS

	Page
Questions Presented	i
Parties to the Proceedings	ii
Table of Contents	iii
Table of Citations	iv
Opinions Below	2
Statement of Jurisdiction	2
Constitutional and Statutory Provisions Involved	2
Statement of the Case	2
Reasons for Denying the Writ	5
I. The Iowa Franchise Act serves no significant or legitimate public purpose sufficient to apply its provisions retroactively.	6
II. The Eighth Circuit properly affirmed the District Court's conclusion that the Iowa Franchise Act substantially impairs the contractual rights in Holiday Inns' existing License Agreements.	12
III. The challenged provisions of the Iowa Franchise Act could not have been anticipated by Holiday Inns when it entered into its Iowa License Agreements.	17
Conclusion	22

Contents

Page

TABLE OF CITATIONS

Cases Cited:

Allied Artists Picture Corp. v. Rhodes, 679 F.2d 656 (6th Cir. 1982) 9

Allied Structural Steel Co. v. Spannaus, 438 U.S. 234 (1978) 5, 7, 12, 13, 17

Anderson's Vehicle Sales, Inc. v. OML-Lincoln, 287 N.W.2d 247 Mich. 1979) 11

Carlock v. Pillsbury Co., 719 F. Supp. 791 (D. Minn. 1989) 20

Chico's Pizza Franchises, Inc. v. Sisemore, 544 F. Supp. 248 (E.D. Wash. 1981), *aff'd without opinion*, 685 F.2d 440 (9th Cir. 1982) 8, 11

Corenswet, Inc. v. Amana Refrigeration, Inc., 594 F.2d 129 (5th Cir.), *cert. denied*, 444 U.S. 938 (1979) 20

Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 U.S. 400 (1983) 5, 7, 8, 9, 10, 13, 17, 19

Exxon Corp. v. Eagerton, 462 U.S. 176 (1983) 10

General Offshore Corp. v. Farrelly, 743 F. Supp. 1177 (D. V.I. 1990) 15

Contents

	Page
Hubbard Chevrolet Co. v. General Motors Corp., 873 F.2d 873 (5th Cir.), *cert. denied*, 493 U.S. 978 (1989)	19
Jacobsen v. Anheuser-Busch, Inc., 392 N.W.2d 868 (Minn. 1986), *cert. denied*, 479 U.S. 1060 (1987)	11, 12
Keystone Bituminous Coal Ass'n v. DeBenedictis, 480 U.S. 470 (1987)	10, 13
Men-Guer Chrysler-Plymouth, Inc. v. Chrysler Corp., No. 93-1806, 63 U.S.L.W. 3257 (U.S. cert. denied, Oct. 3, 1994)	18
Midwest Management Corp. v. Stephens, 291 N.W.2d 896 (Iowa 1980)	20
Modern Computer Systems, Inc. v. Modern Business Systems, Inc., 871 FG.2d 734 (8th Cir. 1989)	9
Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273 (7th Cir. 1992)	19
Schieffelin & Co. v. Department of Liquor Control, 479 A.2d 1191 (Conn. 1984)	11
Troy Ltd. v. Renna, 727 F.2d 287 (3d Cir. 1984)	10
United States Trust Co. v. New Jersey, 431 U.S. 1 (1977) .	7
Wipperfurth v. U-Haul Co., 304 N.W.2d 767 (Wis. 1981) .	12

Contents

Page

Iowa Code Chapter 523H: 2, 3, 5

§ 523H.2 3

§ 523H.5 3

§ 523H.6 3

§ 523H.7 3

§ 523H.8 3

Iowa Code Ann. §§ 322F.1-322F,9 18

Del. Laws, §§ 2552, 2554, 2555 9

Wash. Laws, § 19.100.910 9

Rule Cited:

Eighth Circuit Rule 47B 4

Other Authorities Cited:

16 C.F.R. § 436 (1994) 18

"Franchisor Self-Regulation," Bus. Franchise Guide (CCH) No. 156, at 12 (Dec. 18, 1992) 19

No. 94-618

In The

Supreme Court of the United States

October Term, 1994

STATE OF IOWA, TERRY E. BRANSTAD, and IOWA FRANCHISEE ASSOCIATION,

Petitioners,

vs.

HOLIDAY INNS FRANCHISING, INC., HOLIDAY INNS. INC., and McDONALD'S CORPORATION,

Respondents.

On Joint Petition for Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF IN OPPOSITION OF RESPONDENTS HOLIDAY INNS FRANCHISING, INC. AND HOLIDAY INNS, INC.

Respondents Holiday Inns Franchising, Inc. and Holiday Inns, Inc. respectfully pray that this Court deny Petitioners the State of Iowa, Terry E. Branstad and the Iowa Franchisee Association's Joint Petition for Writ of Certiorari and decline to review the judgment and opinion of the United States Court of Appeals for the Eighth Circuit entered on July 7, 1994.

OPINIONS BELOW

Joint Petitioners the State of Iowa, Terry E. Branstad, and the Iowa Franchisee Association have correctly set forth the citations to the opinions of the United States Court of Appeals for the Eighth Circuit and the United States District Court for the Southern District of Iowa, Central Division, and have attached true and correct copies of those opinions to their Joint Petition for Writ of Certiorari.

STATEMENT OF JURISDICTION

Respondents Holiday Inns Franchising, Inc. and Holiday Inns, Inc. concur in the Joint Petitioners' statement of jurisdiction. There is no dispute among the parties concerning the jurisdiction of this Court properly to consider and decide the timely-filed Joint Petition for Writ of Certiorari.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Joint Petitioners the State of Iowa Terry E. Branstad and the Iowa Franchisee Association have correctly set forth the citations and relevant language of the constitutional provisions of the United States Constitution and of the Constitution of the State of Iowa. Further, Joint Petitioners have properly attached true and correct copies of the relevant portions of the challenged statute of the State of Iowa, the Iowa Franchise Act (Iowa Code Chapter 523H) to their Joint Petition for Writ of Certiorari.

STATEMENT OF THE CASE

The day after its becoming effective, Holiday Inns Franchising, Inc. and Holiday Inns, Inc. (collectively "Holiday Inns") filed an action in the United States District Court for the

Southern District of Iowa, Central Division, challenging the constitutionality of Iowa Code Chapter 523H (the "Iowa Franchise Act" or the "Act"). Holiday Inns named Iowa Governor Terry E. Branstad as a defendant in the action, along with two of its franchisees. At approximately the same time McDonald's Corporation filed a lawsuit challenging the same statute. The Iowa Franchisee Association intervened in both actions.

The Iowa Franchise Act is the most restrictive franchise relationship statute ever enacted. Although several other states have passed legislation regulating various aspects of the franchisor-franchisee relationship, the Iowa Franchise Act goes far beyond the other statutes to restructure completely the fundamental contractual relationship and bargained-for rights of franchisors and franchisees, and even attempts, unlike any other general franchise relationship statutes, to apply retroactively to *existing* franchise agreements. Iowa Code § 523H.2.

Holiday Inns filed a motion for partial summary judgment claiming that retroactive application of at least four provisions of the Act constitutes a substantial impairment of Holiday Inns' existing franchise agreements. The four provisions involve transfer (Iowa Code § 523H.5), encroachment (Iowa Code § 523H.6), termination (Iowa Code § 523H.7), and renewal (Iowa Code § 523H.8). McDonald's filed a similar motion for partial summary judgment challenging the constitutionality of the retroactive application of the same provisions of the Act. All Petitioners resisted the motions, and the State of Iowa and Governor Branstad filed a cross-motion for summary judgment which was resisted by Holiday Inns. The District Court consolidated the two cases for purposes of considering the motions for partial summary judgment and entered one consolidated order.

The District Court, in a thorough and well-reasoned opinion,

held that the application of the challenged provisions of the Iowa Franchise Act to pre-existing contracts violates the Contracts Clauses of the United States and Iowa Constitutions. The District Court separately analyzed each of the challenged statutory provisions and compared each such provision against the relevant section of Holiday Inns' and McDonald's existing contracts with their franchisees. After analyzing the effect of the Act on the relevant contractual provisions, the District Court held that the rights and expectations of the parties to the existing franchise agreements would be materially altered by the statute. (App. 12-22). The District Court further determined that the Act's public purpose to adjust the balance of power between private contracting parties is insufficient to justify the substantial impairment which the Act's provisions have on Holiday Inns' pre-existing License Agreements. (App. 34).[1] The District Court immediately certified the issue for appeal to the Eighth Circuit Court of Appeals.

In reviewing the District Court opinion, the Eighth Circuit held: "The district court, in a detailed and well-considered opinion, held that the retroactive application of these provisions violated both the Iowa and United States Constitutions. . . . We affirm the district court." (App. 4).[2] While the Eighth Circuit provided a more detailed review of one aspect of Contracts Clause jurisprudence, it essentially affirmed based on its agreement with the analysis and conclusions in the District

---

1 Accordingly, the District Court did not reach the last step of Contracts Clause analysis to determine whether the Act's restructuring of the contractual rights of the parties is based on reasonable conditions and of a character appropriate to any public purpose. (App. 34).

2 As is true with all federal courts of appeal, the Eighth Circuit maintains Local Rule 47B to allow it simply to affirm a decision of the district court, in its discretion, with or without further explanation by stating simply: "AFFIRMED. See 8th Cir. R. 47B."

Court's opinion, stating: "[w]e therefore do not see that any useful purpose would be served by a re-examination of the applicable legal principles so ably canvassed and applied by the district court." (App. 4).

Far from departing in any way from established Contracts Clause analysis, the Eighth Circuit, by adopting in full the District Court's thorough, well-reasoned and analytically sound decision, exercised full and appropriate review of the retroactive application of the Iowa Franchise Act and correctly found it to violate the Contracts Clauses of the United States and Iowa Constitutions.

REASONS FOR DENYING THE WRIT

The Joint Petition in this proceeding fails to satisfy *any* of the criteria traditionally applied by this Court in determining whether to grant a writ of certiorari. As Joint Petitioners note, the three-step Contracts Clause analysis has been well-established by this Court: first, a court must determine whether the challenged statute substantially impairs existing contractual rights; second, if substantial impairment is found, the court must review the public purpose of the statute; and third, the court must determine whether the adjustment in contractual rights of the parties is based on reasonable conditions and is of a character appropriate to the public purpose. *See Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 244-45 (1978); *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 411-12 (1983). Joint Petitioners claim that the Eighth Circuit Court of Appeals has disregarded this long-established standard of analysis. But, a closer review of the Eighth Circuit opinion reveals that the Court of Appeals adopted the well-reasoned and thorough opinion of the District Court and that Joint Petitioners' criticism is misplaced. The Eighth Circuit need not rewrite nor reiterate a decision of the lower court which it affirms and adopts in whole.

No other reason exists to grant Joint Petitioners' Petition for Writ of Certiorari: there is no split in the decisions of the federal courts of appeal or between a court of appeal and a state court of last resort; the Eighth Circuit has *not* decided this matter in conflict with existing Supreme Court decisions; and the Eighth Circuit has not so far departed from accepted judicial proceedings to require review by the Supreme Court. The Eighth Circuit affirmed a District Court opinion which carefully and exhaustively followed the well-established Contracts Clause analysis and correctly found the Iowa Franchise Act to violate the Constitutions of both the United States and of the State of Iowa. The Joint Petition therefore should be denied.

I.

THE IOWA FRANCHISE ACT SERVES NO SIGNIFICANT OR LEGITIMATE PUBLIC PURPOSE SUFFICIENT TO APPLY ITS PROVISIONS RETROACTIVELY.

It is important to note initially that there is no significant dispute between Holiday Inns and the Joint Petitioners, either here or in the courts below, as to the proper framework for analyzing this Contracts Clause question.[3] The relevant issue here is whether the Eighth Circuit actually performed this Contracts Clause analysis in affirming the opinion of the District Court without restating the analysis used by the District Court. Because the Eighth Circuit adopted in full the analysis and conclusions of the District Court, the Eighth Circuit was not required to issue its own lengthy opinion in order to affirm the lower court.

---

3 All parties further agree that the analyses are identical for constitutional challenges under the United States and the Iowa Constitutions.

Joint Petitioners claim that the Eighth Circuit did not consider the public purpose of the Act and, thus, failed to apply the legal standard mandated by this Court. This argument is incorrect. The Eighth Circuit did review and affirm the opinion of the District Court which included a thorough analysis of the public purpose issue. The appellate court did not have to repeat that opinion word for word.

Joint Petitioners have raised no issue concerning the Eighth Circuit's and the District Court's review of the public purpose of the Act sufficient for this Court to grant a writ of certiorari. The District Court, having found that the Iowa Franchise Act substantially impairs pre-existing Holiday Inns License Agreements, further determined that the Act fails the second step of the *Allied Structural Steel* test because it serves no significant or legitimate public purpose and is merely special-interest legislation. (App. 34). *See Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 245 (1978); *Energy Reserves*, 459 U.S. at 411-12. The District Court expressly considered the evidence presented by affidavit and in the legislative history of the Act concerning its purported purpose and found that the State had not shown a sufficient public purpose to allow retroactive application of the Act. (App. 31-32). The Eighth Circuit affirmed that decision. (App. 4).

In deciding that the public purpose of the Act was insufficient to sustain retroactive application to existing contracts, the District Court cited numerous Supreme Court precedents as well as precedents from other federal and state courts. *See, e.g., Allied Structural Steel*, 438 U.S. at 234; *United States Trust Co. v. New Jersey*, 431 U.S. 1 (1977). The District Court applied precisely the test articulated by those courts. It did not weaken or alter the standard in any way. The simple fact that the Eighth Circuit did not restate the District Court's exhaustive

analysis does not mean that the appellate court applied a weaker standard.[4]

The District Court correctly found that the purpose of the Act is to equalize bargaining power and contractual rights between franchisees and franchisors. The question presented to this Court is whether the Eighth Circuit and the District Court disregarded existing precedent in holding that this purpose was not sufficient to justify applying the Act retroactively to substantially impair Holiday Inns' existing License Agreements.

Readjusting private contractual rights for the benefit of a limited class of persons, such as franchisees, is *not* a legitimate public purpose sufficient to justify retroactive application of the Iowa Act. *See, e.g., Chico's Pizza Franchises, Inc. v. Sisemore*, 544 F. Supp. 248, 249-50 (E.D. Wash. 1981), *aff'd without opinion*, 685 F.2d 440 (9th Cir. 1982). Joint Petitioners have cited no case authority that such a purpose is sufficient to sustain retroactive application of a statute that substantially impairs existing contractual rights, as opposed to prospective economic regulation.[5] The test of the public purpose employed in cases

---

4 Accordingly, Joint Petitioners are incorrect in claiming that the Eighth Circuit has adopted a form of "strict scrutiny" for any legislation which impairs existing contracts. As the District Court pointed out, the level of scrutiny to which the public purpose of a statute will be subjected is directly related to the severity of the impairment of the contractual rights of the parties. (App. 26) (citing *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 411 (1983)). Because the challenged provisions of the Act radically alter Holiday Inns' rights under its pre-existing License Agreements, the level of scrutiny applied by the District Court and affirmed by the Eighth Circuit was entirely appropriate.

5 Joint Petitioners cite to several law review articles which list and discuss the various franchise laws across the country. Significantly, none of the various general franchise laws across the country has encroachment or such

(Cont'd)

involving retroactive application of a statute is more stringent than in those involving prospective application. The State of Iowa must show that the Act has a "significant and legitimate" public purpose in order to apply it retroactively, not just that the Act is rationally related to the alleged governmental interest. *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 411-12 (1983). The analysis in cases involving prospectively applied statutes is more deferential than the "public purpose" prong of the Contracts Clause analysis and is more analogous to the final phase of the analysis, *i.e.*, whether the challenged statute is rationally drawn to meet the purpose being advanced.

One federal court of appeals has concluded that "a state's interest in righting a bargaining imbalance, standing alone, is not sufficient" to allow *prospective* regulation of a private business relationship. *Allied Artists Picture Corp. v. Rhodes*, 679 F.2d 656, 665 (6th Cir. 1982). If equalizing a bargaining imbalance is not a legitimate purpose to justify such *prospective* regulation, it is surely insufficient to justify direct impairment of Holiday Inns'

(Cont'd)
restrictive transfer provisions. Moreover, the franchise laws of all states except Delaware and Washington do not purport to apply retroactively. The franchise laws of Delaware and Washington apply retroactively only to imply a requirement of good faith and fair dealing into all contracts, including franchise agreements, and to require notice before termination, as otherwise required by common law. Del. §§ 2552, 2554 and 2555; Wash. § 19.100.910.

Further, Joint Petitioners cite to *Modern Computer Systems, Inc. v. Modern Business Systems, Inc.*, 871 F.2d 734, 739 (8th Cir. 1989), as though it supports the notion that franchisors generally take advantage of franchisees. A complete reading of the language quoted by Joint Petitioners demonstrates that although the court recognized that franchising literature reports numerous instances of abuse by franchisors, "we do not believe that the facts in this case fit that stereotype." *Id.* The court indicates that some specific evidence of abuse must be found to disregard the mutually agreed-upon contract language.

pre-existing contractual rights.[6] The District Court therefore correctly concluded that the Act has no significant and legitimate public purpose and that its retroactive application is unconstitutional.

As the District Court pointed out, the State of Iowa needed to have shown that the public purpose behind the Act was to remedy "a broad and general social or economic problem. The requirement of both a significant and legitimate public purpose 'guarantees that the State is exercising its police power, rather than providing a benefit to special interests.' " (App. 31) (quoting *Energy Reserves*, 459 U.S. at 412). Cases sustaining the retroactive application of a state statute against Contracts Clause challenges have required the statute not to "prescribe a rule limited in effect to contractual obligations or remedies, but instead [to] impose a generally applicable rule of conduct designed to advance 'a broad societal interest.' " (App. 33) (quoting *Exxon Corp. v. Eagerton*, 462 U.S. 176, 191 (1983)). *See, e.g., Keystone Bituminous Coal Ass'n v. DeBenedictis*, 480 U.S. 470, 502-05 (1987) (state had strong public interest in legislation regulating environmental effects of mining operations on landowners).

Joint Petitioners cite three cases as analogous federal and state court decisions with which the Eighth Circuit's decision here allegedly conflicts. None of these opinions is directly on point. First, *Troy Ltd. v. Renna*, 727 F.2d 287 (3d Cir. 1984), involved a statute which merely enlarged a pre-existing tenancy which came into operation as a matter of law. Thus, the statute

---

6 Regarding the equalization of bargaining power between parties, this Court should note that it is manifestly impossible for any government action to equalize the bargaining power between parties to a pre-existing agreement. The bargaining is completed; the agreement has been reached. Therefore, equalizing bargaining power cannot be a significant and legitimate public purpose to sustain retroactive application.

did not impair the parties' contractual rights at all. Further, the purpose of the act was to protect the mental and physical health and safety of senior citizens by preventing their relocation or eviction, which obviously is a more significant and generally applicable public purpose than readjusting the rights of private contracting parties.

Second, *Schieffelin & Co. v. Department of Liquor Control*, 479 A.2d 1191 (Conn. 1984), involved a change in the regulation of the notice requirement for termination of liquor distributorships. Third, *Anderson's Vehicle Sales, Inc. v. OML-Lincoln*, 287 N.W.2d 247 (Mich. 1979), involved notice and good cause requirements imposed on automobile dealership agreements as a codification of the common law governing contracts. The industries regulated by the new statutes in *Schieffelin* and *Anderson* are universally recognized as sufficiently highly-regulated to forewarn those parties that further regulation is likely. As the courts below correctly noted, neither franchising in general nor the hotel industry in particular fits that characterization.

The Eighth Circuit's affirmance of the District Court's opinion is in line with decisions of other federal courts of appeal and state courts of last resort which almost uniformly have stricken down retroactive application of franchise statutes supported by public purposes similar to the one here. *See Chico's Pizza Franchises*, 544 F. Supp. at 248 (E.D. Wash. 1981), *aff'd without opinion*, 685 F.2d 440 (9th Cir. 1982) (the court declared unconstitutional the Washington Franchise Investment Protection Act because its purpose did not justify retroactive application); *Jacobsen v. Anheuser-Busch, Inc.*, 392 N.W.2d 868 (Minn. 1986) (the Minnesota Supreme Court refused to allow retroactive application of a statute which benefitted wholesale beer distributors finding it special interest legislation without sufficient legitimate public purpose), *cert. denied*, 479 U.S. 1060

(1987); *Wipperfurth v. U-Haul Co.*, 304 N.W.2d 767 (Wis. 1981) (the Wisconsin Supreme Court struck down the retroactive application of a state automobile dealership franchise law because it was not necessary to the vital interests of the people of the State).

In reviewing the public purpose of the Act, the District Court and the Eighth Circuit meticulously followed the Contracts Clause analysis prescribed by the Supreme Court and followed by other federal and state courts. The District Court found that the stated public purpose was insufficient to allow retroactive application of a statute that so substantially impaired the rights articulated in existing Holiday Inns License Agreements. The Eighth Circuit affirmed that conclusion. Although Joint Petitioners may not be satisfied with the outcome of the District Court's review, they articulate no reasons to justify this Court's grant of a Writ of Certiorari.

II.

THE EIGHTH CIRCUIT PROPERLY AFFIRMED THE DISTRICT COURT'S CONCLUSION THAT THE IOWA FRANCHISE ACT SUBSTANTIALLY IMPAIRS THE CONTRACTUAL RIGHTS IN HOLIDAY INNS' EXISTING LICENSE AGREEMENTS.

The starting point to determine whether a challenged statute violates the Contracts Clause of the Constitutions of the United States or the State of Iowa is whether the statute in question substantially impairs the existing rights of parties to an actual contract. *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 244-45 (1978). Joint Petitioners and Holiday Inns agree that in order to determine whether contractual rights have been substantially impaired, a court must first review the contractual rights at issue and the nature of the impact of the statutory

provisions on those rights. *Keystone Bituminous Coal Ass'n v. DeBenedictis*, 480 U.S. 470, 504 (1987). The factors to be weighed in making this assessment include the severity of the impairment, the extent to which the challenged statute frustrates a party's reasonable expectations, and the extent to which the subject matter of the impairment has been regulated in the past. *Allied Structural Steel*, 438 U.S. at 245-46. The District Court followed this step of Contracts Clause analysis and thoroughly reviewed the nature and extent of the impairment of Holiday Inns' contractual rights under its License Agreements caused by the challenged statutory provisions of the Act.

The District Court further noted that the level of scrutiny with which it reviews a statute is determined by the extent to which the contractual rights of the parties are impaired. " 'The severity of the impairment is said to increase the level of scrutiny to which the legislation will be subjected. Total destruction of contractual expectations is not necessary for a finding of substantial impairment.' " (App. 26) (quoting *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 411 (1983) (citation omitted)). Joint Petitioners overstate the degree of impairment required to satisfy this first prong of the Contracts Clause test, implying that the State has virtually unlimited police power to alter private contracts by regulation. Where, as here, a statute creates new rights for one party while substantially restricting or even eliminating the existing rights of the other party, a substantial impairment must be found to exist and the District Court properly so held.

Moreover, Joint Petitioners mischaracterize the real issue in the substantial impairment analysis. The issue in determining whether the Act substantially impairs Holiday Inns' contracts is *not* whether the Act totally prohibits Holiday Inns from engaging in certain conduct, such as terminating or refusing to renew a franchisee, in the abstract. The issue instead is whether the

restrictions in the Act impair or abrogate significant rights Holiday Inns possesses under its pre-existing License Agreements. The District Court correctly decided this issue, and the Eighth Circuit affirmed that the Act does substantially impair Holiday Inns' contractual rights.

Joint Petitioners take issue with the fact that the Eighth Circuit's discussion of the substantial impairment issue consists of a "reference to" the District Court's finding of substantial impairment. Such reference, however, is both appropriate and sufficient. The District Court undertook a detailed review of the contractual relationship between Holiday Inns and its franchisees. (App. 12-22). The District Court analyzed the nature and importance of the contractual clauses from Holiday Inns' License Agreements that were effected by the challenged provisions of the Act. (App. 12-22). The District Court evaluated the impact the Act has on Holiday Inns' contractual rights, and determined that the Act impaired the contractual relationship to a substantial degree. (App. 15-31). While Joint Petitioners may not agree with the outcome of that analysis, they cannot deny that the District Court undertook such analysis and employed the proper legal framework. The Eighth Circuit's adoption and affirmance of the District Court's reasoning and conclusion that the Act impairs Holiday Inns' pre-existing contracts is both appropriate and, under these circumstances, absolutely correct.

The Eighth Circuit clearly was not required to issue its own opinion engaging in a lengthy Contracts Clause exposition which merely parroted the District Court's analysis. Joint Petitioners' argument that the Eighth Circuit should have done just that offends judicial economy and common sense. Such an argument certainly provides no basis for granting certiorari in this case.

Joint Petitioners also incorrectly contend that the Eighth Circuit should have required Holiday Inns "to demonstrate the

extent" to which the Act modified Holiday Inns' rights by providing evidence that Holiday Inns intended eminently to exercise those rights. Joint Petitioners suggest that requiring Holiday Inns to prove that it had planned either to terminate or refuse to renew its franchise agreements is consistent with the incremental "approach to assessment of 'substantial impairment'" adopted in *General Offshore Corp. v. Farrelly*, 743 F. Supp. 1177 (D.V.I. 1990).

To the extent *General Offshore* even states the appropriate standard of analysis, it is readily distinguished from the situation here. The *General Offshore* court found it significant that local case law had *already* restricted the right of an employer to terminate an employee at will. The plaintiff in that case contended that its right to discharge employees was substantially impaired by a statute which provided a list of circumstances under which an employer *could* terminate an employee. *Id.* at 1197-98. The court there also noted that an employer and employee were "free to contract around the statute by creating additional reasons for discharge," which further mitigated the effect of the statute, but that the statute did not absolutely prohibit discharge. *Id.* at 1199 n.17.

Neither the rationale of *General Offshore* nor the interpretation of it urged by Joint Petitioners is applicable here. Iowa case law has not previously restricted Holiday Inns' ability to exercise its relevant rights under its License Agreements. Further, Holiday Inns cannot preserve or resurrect its pre-existing contractual rights by entering into a new agreement with its franchisees after the provisions of the Act take effect. Thus, *General Offshore* does not support the constitutionality of the Act's retroactive application. More importantly, existing Contracts Clause jurisprudence from this Court clearly does not require Holiday Inns to prove that it planned eminently to

exercise its pre-existing contractual rights before a substantial impairment may be found.[7]

In sum, the Eighth Circuit affirmed that the District Court properly applied the appropriate legal principles, stating:

> We do not think it can be seriously contested that the retroactive feature of the relevant Iowa legislation substantially impaired the obligations previously owed to the plaintiffs in this case, or that this dispute is ripe for adjudication. We therefore do not see that any useful purpose would be served by a re-examination of the applicable legal principles so ably canvassed and applied by the district court.

(App. 4).[8] Under the undisputed facts of this case, this decision is clearly correct. Because the courts below both applied the proper Contracts Clause analysis and reached the proper result, this Court should deny the Joint Petition for Writ of Certiorari.

---

7 Joint Petitioners' contention that Holiday Inns was required to demonstrate to the District Court and to the Eighth Circuit that it intended to exercise the rights it possessed under its contracts appears to raise an issue of standing or ripeness to challenge the Act. Each of those claims was raised and rejected below but have *not* been pursued here by Joint Petitioners.

8 Having thus affirmed the District Court's opinion, the Eighth Circuit simply goes on to offer observations "on a very troublesome aspect of current Contract Clause jurisprudence." (App. 4). The comments by the Eighth Circuit to clarify one aspect of Contract Clause jurisprudence do not detract from the Court's affirmance and adoption of the District Court opinion.

III.

THE CHALLENGED PROVISIONS OF THE IOWA FRANCHISE ACT COULD NOT HAVE BEEN ANTICIPATED BY HOLIDAY INNS WHEN IT ENTERED INTO ITS IOWA LICENSE AGREEMENTS.

One relevant factor in determining whether a state statute substantially impairs existing contractual rights is whether the kind of contract or relationship which is the subject matter of the dispute had been previously regulated. *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 250 (1978); *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. at 400, 411 (1983). Like the District Court, the Eighth Circuit made a detailed analysis of this particular aspect of Contracts Clause jurisprudence as articulated by the Supreme Court. As the Eighth Circuit observed:

> The idea, evidently, is that if the party to the contract who is complaining could have seen it coming, it cannot claim that its expectations were disappointed. To put it in economic terms, a party's evaluation of the possibility of interference is reflected in the negotiated price, and thus the value of performance to it is not reduced, if it can more or less accurately value the risk of that interference. We believe that this is the principle that the Supreme Court is developing in its cases.

(App. 5).

The Eighth Circuit went on to note that while Iowa had enacted franchise regulation statutes in five specific (and traditionally regulated) industries, it had never attempted to

regulate franchise relationships in general or in the hotel or fast food industries in particular. Moreover, only one of those industry-specific statutes purported to be retroactive and then not generally so. (App. 5). (*See* Iowa Code Ann. §§ 322F.1-322F.9). The Eighth Circuit further noted that reference by Appellants, and here by Joint Petitioners, to statutes from other jurisdictions which they claim are similar to the Iowa Franchise Act fails from the same infirmity: those statutes do not purport to apply retroactively. (App. 6). On this point the Eighth Circuit explained in some detail its conclusion, which is identical to that of the District Court:

> It is absolutely plain, moreover, that the [retroactive] application of statutes similar to the one here, and in the circumstances that are present in this case, has almost uniformly been held unconstitutional, and this is a datum on which franchisors are presumably allowed to rely while bargaining and in fixing the prices of their licenses.

(App. 6) (citations omitted).[9]

In addition, there has *never* been any generally applicable federal regulation of franchise relationships. The only regulation at the federal level has been the Federal Trade Commission Franchise Rule, 16 C.F.R. § 436 (1994), which merely requires certain pre-sale disclosures and does not purport to regulate the post-sale relationship. Further, the fact that franchise relationship bills have been introduced in Congress certainly is not persuasive

---

9 Indeed, this Court recently denied review of a ruling that retroactive application of the termination and encroachment provisions of the Ohio motor vehicle dealer law was unconstitutional. ***Men-Guer Chrysler-Plymouth, Inc. v. Chrysler Corp.***, No. 93-1806, 63 U.S.L.W. 3257 (U.S. ***cert. denied***, Oct. 3, 1994).

because the case law focuses on statutes and regulations in existence *at the time the contracts were entered into. See Energy Reserves*, 459 U.S. at 400.

Similarly, Joint Petitioners' attempt to portray the franchise industry as heavily regulated, and indeed as self-regulated, by virtue of the International Franchise Association's ("IFA") proposed Code of Ethics clearly is not persuasive. The IFA's Code of Ethics did not exist at the time Holiday Inns entered into its License Agreements nor was it even in existence at the time the Act was passed. *See* "Franchisor Self-Regulation," Bus. Franchise Guide (CCH) No. 156, at 12 (Dec. 18, 1992). Indeed, the Code of Ethics, by its own terms, was approved "[i]n the wake of the enactment of the controversial Iowa franchise law." *Id.*[10]

Joint Petitioners' attempt to rely on prior judicial precedent and common law fares no better. While courts have recognized an implied covenant of good faith in franchise agreements, as in all contracts, they have varied widely in their interpretations of the nature and scope of that duty. It is clear, however, that the implied covenant of good faith and fair dealing only governs the exercise of rights by parties to a contract where the contract grants one party discretion in performance. *See, e.g., Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd.*, 970 F.2d 273, 280 (7th Cir. 1992) (implied covenant imposes duty not to "tak[e] advantage of gaps in a contract in order to exploit the vulnerabilities" therein); *Hubbard Chevrolet Co. v. General Motors Corp.*, 873 F.2d 873, 876-77 (5th Cir.) (implied covenant supplies limits on parties' conduct when contract defers decision on particular term or is ambiguous), *cert. denied*, 493 U.S. 978 (1989). Moreover, implying a covenant of

---

10 Moreover, the Code of Ethics has since been modified by the International Franchise Association as a "Code of Principles and Standards of Conduct" and has become something far less restrictive than initially conceived.

good faith neither creates new rights independent of the contract nor can it override the express terms of the contract. *Corenswet, Inc. v. Amana Refrigeration, Inc.*, 594 F.2d 129, 138 (5th Cir.), *cert. denied*, 444 U.S. 938 (1979); *Carlock v. Pillsbury Co.*, 719 F. Supp. 791, 812 (D. Minn. 1989). By contrast, the Iowa Franchise Act goes much farther than existing common law in that it actually nullifies existing rights under Holiday Inns' License Agreements and grants completely new rights not contemplated in the pre-existing contracts. (App. 12-22).

Further, Joint Petitioners have suggested that one prior Iowa Supreme Court case, *Midwest Management Corp. v. Stephens*, 291 N.W.2d 896 (Iowa 1980), creates common law which they claim that the Act codifies. Contrary to this assertion, *Midwest* simply repeats that terminations should not be arbitrary, *id.* at 913, while suggesting no specific regulation of franchises or franchise agreements and, in fact, without even dealing with franchises at all. Thus, prior judicial regulation by the courts of Iowa does not provide a sufficient basis to support the Act's retroactive application.

Finally, Joint Petitioners argue that the existence of legal and political commentary regarding franchise relationships should have put Holiday Inns on notice of impending regulation as drastic as the Iowa Act. Such law review articles and commentary, however, demonstrate only that franchising has been a much discussed area of law and business but does not show that it has been a highly regulated one. Joint Petitioners have provided no case authority indicating that such commentary is even relevant to the issue of prior regulation.

In sum, the Eighth Circuit completely and correctly addressed the issue of whether there has been a sufficient history of regulation of franchises in general and of the hotel industry in particular in the state of Iowa and elsewhere to justify the

imposition of the Iowa Franchise Act. Joint Petitioners do not even attempt to contend and cannot claim that they have raised an issue concerning prior regulation which would meet the criteria traditionally applied by this Court in determining whether to grant a writ of certiorari. They have not raised such issue, and the writ should be denied.

CONCLUSION

Accordingly, for all the foregoing reasons, Petitioners' request for a writ of certiorari should be denied.

Dated: November 7, 1994.

Respectfully submitted,

JOHN G. PARKER
Counsel of Record
RONALD T. COLEMAN, JR.
JANET L. KISHBAUGH
PAUL, HASTINGS, JANOFSKY & WALKER
4200 Georgia-Pacific Center
133 Peachtree Street, N.E.
Atlanta, GA 30303-1840
(404) 588-9900
FAX (515) 523-1542

EDWARD W. REMSBURG
AHLERS, COONEY, DORWEILER, HAYNIE, SMITH & ALLBEE, P.C.
Suite 600
100 Court Avenue
Des Moines, IA 50309-2231
(515) 243-7611
FAX (515) 243-2149

Attorneys for Respondents Holiday Inns Franchising, Inc. and Holiday Inns, Inc.